(1)

88-181

No. ——

Supreme Court, U.S.
FILED
AUG 1 1988
JOSEPH F. SPANIOL, JR.
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

HOUSTON LIGHTING & POWER COMPANY,
Appellant,

v.

PUBLIC UTILITY COMMISSION OF TEXAS,
Appellee.

On Appeal from the Supreme Court of Texas

JURISDICTIONAL STATEMENT

HUGH RICE KELLY
HOUSTON LIGHTING & POWER COMPANY
Post Office Box 61867
Houston, TX 77208
(713) 229-7265

ROBERT J. HEARON, JR.
GRAVES, DOUGHERTY, HEARON & MOODY
Post Office Box 98
Austin, TX 78767
(512) 480-5600

EDGAR M. ROACH, JR.*
MARY NASH K. RUSHER
HUNTON & WILLIAMS
One Hannover Square
Raleigh, NC 27601
(919) 899-3000

GREGORY EVERS MAY
HUNTON & WILLIAMS
2000 Pennsylvania Ave., N.W.
Washington, DC 20006
(202) 955-1500

Attorneys for Houston Lighting & Power Company

August 1, 1988

* Counsel of Record

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

QUESTIONS PRESENTED

1. Whether a public utility rate order takes property without just compensation when it gives to ratepayers the benefit of a tax deduction for costs that were not paid by the ratepayers.

2. Whether a state utility commission denies due process of law to a public utility when it bases rates on a determination not made on the ratemaking record.

PARTIES BELOW

The petitioner in the Texas Supreme Court was the Public Utility Commission of Texas. The respondents were Houston Lighting & Power Company, Dow Chemical Company, Diamond Shamrock Company, Texas-New Mexico Power Company, Texas Industrial Energy Consumers, and the Cities of Houston, Lake Jackson, and Friendswood, Texas.

RULE 28.1 STATEMENT

Houston Lighting & Power Company ("HL&P") is a wholly-owned subsidiary of Houston Industries Incorporated, which is a publicly-held company. HL&P has no other publicly-held affiliates or subsidiaries.

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED	i
PARTIES BELOW	ii
RULE 28.1 STATEMENT	ii
TABLE OF AUTHORITIES	v
OPINIONS BELOW	1
JURISDICTION	1
CONSTITUTIONAL AND STATUTORY PROVISIONS	2
STATEMENT OF THE CASE	2
THE QUESTIONS PRESENTED ARE SUBSTANTIAL	5
I. This Case Presents Issues of National Significance	5
II. The Use of Tax Benefits from Nonutility Property to Reduce Utility Rates Is an Unconstitutional Taking	12
III. A Ratemaking Determination Made Without Any Basis in the Record is a Denial of Due Process	20
CONCLUSION	22

TABLE OF CONTENTS—Continued

APPENDICES * Page

Appendix A—Judgment and Opinion of the Texas Supreme Court (December 16, 1987) 1a

Appendix B—Order Denying Rehearing by the Texas Supreme Court, with Dissent (May 4, 1988) 10a

Appendix C—Judgment and Opinion of the Court of Appeals of Texas at Austin (July 2, 1986) 15a

Appendix D—Final Judgment of the District Court of Travis County (September 13, 1984) 37a

Appendix E—Final Order of the Public Utility Commission of Texas, together with Examiner's Report, Docket No. 4540 (December 6, 1982) 44a

Appendix F—Order of the Public Utility Commission of Texas Denying Rehearing (December 31, 1982) 167a

Appendix G—Notice of Appeal (July 21, 1988) 170a

Appendix H—Excerpts from the Texas Public Utility Regulatory Act as in Effect Before September 1, 1983 ..... 172a

Appendix I—Excerpts from the Texas Public Utility Regulatory Act as Effective September 1, 1983 ..... 177a

* The Appendices have been bound separately pursuant to Rule 15.1(j).

TABLE OF AUTHORITIES

CASES

	Page
Acker v. United States, 298 U.S. 426 (1936)	15
Agins v. Tiburon, 447 U.S. 255 (1980)	19
Application of Hawaiian Telephone Co., 67 Haw. 370, 689 P.2d 741 (1984)	11
Arkansas Electric Coop. Corp. v. Arkansas Public Service Comm'n, 461 U.S. 375 (1983)	2
Armstrong v. United States, 364 U.S. 40 (1960)	18, 19
Barasch v. Pennsylvania Public Utility Comm'n, 516 Pa. 142, 532 A.2d 325 (1987), *prob. juris. noted sub nom., Duquesne Light Co. v. Barasch*, 108 S.Ct. 1105 (1988)	12
Bluefield Waterworks & Improvement Co. v. Public Service Comm'n, 262 U.S. 679 (1923)	15
Board of Public Utility Comm'rs v. New York Telephone Co., 270 U.S. 23 (1926)	14
Brooks-Scanlon Co. v. Railroad Comm'n, 251 U.S. 396 (1920)	16
Charlottesville v. Federal Energy Regulatory Comm'n, 774 F.2d 1205 (D.C. Cir. 1985), *cert. denied*, 475 U.S. 1108 (1986)	14
The Chicago Junction Case, 264 U.S. 258 (1924)	20
Cleveland Electric Illuminating Co. v. Public Utilities Comm'n, 4 Ohio St. 3d 107, 447 N.E.2d 746 (1983), *appeal denied*, 464 U.S. 802 (1983)	11
Connolly v. Pension Benefit Guaranty Corp., 106 S. Ct. 1018 (1986)	18
Dayton Power Co. v. Public Utilities Comm'n, 4 Ohio St. 3d 91, 447 N.E.2d 773 (1983)	12
Driscoll v. Edison Light & Power Co., 307 U.S. 104 (1939)	11
Dunlop v. Bachowski, 421 U.S. 560 (1975)	20
Duquesne Light Co. v. Barasch, 108 S. Ct. 1105 (1988), *noting prob. juris. in Barasch v. Pennsylvania Public Utility Comm'n*, 516 Pa. 142, 532 A.2d 325 (1987)	12
Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944)	*passim*
Federal Power Comm'n v. United Gas Pipe Line Co., 386 U.S. 237 (1967)	14

TABLE OF AUTHORITIES—Continued

	Page
Federal Radio Comm'n v. Nelson Bros. Bond & Mortgage Co., 289 U.S. 266 (1933)	20
Fuentes v. Shevin, 407 U.S. 67 (1972)	20
Hodel v. Irving, 107 S. Ct. 2076 (1987)	17, 19
Interstate Commerce Comm'n v. Louisville & Nashville Railroad, 227 U.S. 88 (1913)	20
Kaiser Aetna v. United States, 444 U.S. 164 (1979)	17
Kansas City Power & Light Co. v. State Corporation Comm'n, 232 Kan. 483, 720 P.2d 1063 (1986), *prob. juris. noted*, 107 S. Ct. 1281, *appeal dismissed*, 107 S. Ct. 3280 (1987)	12
Kansas Gas & Electric Co. v. State Corporation Comm'n, 232 Kan. 483, 720 P.2d 1063 (1986), *prob. juris. noted*, 107 S. Ct. 1281, *appeal dismissed*, 107 S. Ct. 2171 (1987)	12
Keystone Bituminous Coal Ass'n v. DeBenedictis, 107 S. Ct. 1232 (1987)	18, 19
Legislative Utility Consumers' Council v. Public Service of New Hampshire, 119 N.H. 332, 402 A.2d 626 (1979)	11
Mathews v. Eldridge, 424 U.S. 319 (1976)	19
Miller v. Schoene, 276 U.S. 272 (1928)	18
Mississippi River Fuel Corp. v. Federal Power Comm'n, 163 F.2d 433 (D.C. Cir. 1947)	14
Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Comm'n, 262 U.S. 272 (1923)	14, 15
Munn v. Illinois, 94 U.S. 113 (1877)	16
Nantahala Power & Light Co. v. Thornburg, 476 U.S. 953 (1986)	1
Northern Pacific Railway v. Department of Public Works, 268 U.S. 39 (1925)	20
Northern Pacific Railway v. North Dakota, 236 U.S. 585 (1915)	16
Penn Central Transportation Co. v. New York, 438 U.S. 104 (1978)	20
Permian Basin Area Rate Cases, 390 U.S. 747 (1968)	11, 15

TABLE OF AUTHORITIES—Continued

Page

Railroad Comm'n v. High Plains Natural Gas Co., 628 S.W.2d 753 (Tex. 1981) 15
Railroad Comm'n v. Pacific Gas & Electric Co., 302 U.S. 388 (1938) 20
Ruckelshaus v. Monsanto Co., 467 U.S. 986 (1984) 17, 19
Savanah Electric & Power Co. v. Public Service Comm'n, 239 Ga. 156, 236 S.E.2d 87 (1977) 11
Suburban Utility Corp. v. Public Utility Comm'n, 652 S.W.2d 358 (Tex. 1983) 15
United States v. General Motors Corp., 323 U.S. 373 (1945) 19
United States v. Morton Salt Co., 338 U.S. 632 (1950) 21
Washington Gas Light Co. v. Public Service Comm'n, 450 A.2d 1187 (D.C. 1982) 11
Webb's Fabulous Pharmacies, Inc. v. Beckwith, 449 U.S. 155 (1980) 17, 18
West Ohio Gas Co. v. Public Utilities Comm'n, 294 U.S. 63 (1935) 15

ADMINISTRATIVE DECISIONS

In re Boston Edison Co., Docket No. 85-266A (Mass. Dep't of Pub. Util. June 26, 1986) 10
In re Central Illinois Light Co., 57 P.U.R.4th 351 (Ill. Commerce Comm'n 1983) 8
In re Central Vermont Public Service Corp., 86 P.U.R.4th 114 (Vt. P.S.C. 1987) 9
In re Commonwealth Electric Co., 47 P.U.R.4th 229 (Mass. Dep't of Pub. Util. 1982) 8
In re Detroit Edison Co., 52 P.U.R.4th 318 (Mich. P.S.C. 1983) 8
In re Maine Public Service Co., 67 P.U.R.4th 101 (Me. P.U.C. 1985) 8
In re Union Electric Co., 74 P.U.R.4th 80 (Mo. P.S.C. 1986) 8
In re United Illuminating Co., 55 P.U.R.4th 252 (Conn. Dep't of Pub. Util. Control 1983) 8

TABLE OF AUTHORITIES—Continued

	Page
Washington Utilities & Transportation Comm'n v. Pacific Power & Light Co., 78 P.U.R.4th 84 (Wash. Util. & Transp. Comm'n 1986)	8
CONSTITUTION	
U.S. Const., amend. V, cl. 4	*passim*
U.S. Const., amend. XIV, § 1, cl. 3	*passim*
STATUTES AND REGULATIONS	
I.R.C. § 165(a)	9, 18
I.R.C. § 167(a)	9
I.R.C. § 263(a)	9
Tex. Rev. Civ. Stat. Ann. art. 6252-13a	21
Tex. Rev. Civ. Stat. Ann. art. 1446c, § 35(a)	14
Tex. Rev. Civ. Stat. Ann. art. 1446c, § 39(a)	15
Tex. Rev. Civ. Stat. Ann. art. 1446c, § 40(a)	15
Tex. Rev. Civ. Stat. Ann. art. 1446c, § 41(c)(3)	15
Treas. Reg. § 1.165-1	9
Treas. Reg. § 1.263(a)-1	9
5 U.S.C. §§ 501 *et seq.*	20
15 U.S.C. §§ 717 *et seq.*	14
28 U.S.C. § 1257	1, 2
28 U.S.C. § 1342	11
OTHER	
Edison Electric Institute, *Regulatory Treatment of Cancelled Plants: Survey and Analysis of Cases* (1986)	7, 8
Energy Information Administration, United States Department of Energy, *Nuclear Plant Cancellations: Causes, Costs and Consequences* (April 1983)	6, 7
C. Phillips, *The Regulation of Public Utilities* (1984)	7, 14
Plant Construction Is Spiraling Down, Says UDI Report, Electric Light & Power, April 1988	10
Rodgers and Gray, *State Commission Treatment of Nuclear Plant Cancellation Costs*, 13 Hofstra L. Rev. 443 (1985)	4

TABLE OF AUTHORITIES—Continued

Page

Salomon Brothers, Inc, *Stock Research: Nuclear Construction Utilities* (February 1987) 7
United States Department of Energy, *Energy Security—A Report to the President of the United States* (March 1987) 7, 10

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

No. ———

HOUSTON LIGHTING & POWER COMPANY,
Appellant,

v.

PUBLIC UTILITY COMMISSION OF TEXAS,
Appellee.

On Appeal from the Supreme Court of Texas

JURISDICTIONAL STATEMENT

OPINIONS BELOW

The opinion of the Texas Supreme Court (Appendix A) is reported at 748 S.W.2d 439. The opinion of the Texas Court of Appeals for the Third Supreme Judicial District (Appendix C) is reported at 715 S.W.2d 98. The opinion of the District Court of Travis County dated September 13, 1984 (Appendix D) is not reported. The order of the Public Utility Commission of Texas dated December 6, 1982, together with the Examiner's Report dated November 9, 1982 (Appendix E), are reported at 50 P.U.R. 4th 157 (1982).

JURISDICTION

The Texas Supreme Court issued its opinion on December 16, 1987, and denied rehearing on May 4, 1988. HL&P filed timely Notice of Appeal in the Texas Supreme Court on July 21, 1988. (Appendix G). This Court has appellate jurisdiction under 28 U.S.C. § 1257 (2). *See Nantahala Power & Light Co. v. Thornburg,*

476 U.S. 953 (1986).[1] Alternately, this Court has jurisdiction under 28 U.S.C. § 1257(3).

CONSTITUTIONAL AND STATUTORY PROVISIONS

The United States Constitution, Amendment V, clause 4:

> [N]or shall private property be taken for public use, without just compensation.

The United States Constitution, Amendment XIV, § 1, clause 3:

> [N]or shall any State deprive any person of . . . property, without due process of law . . . .

The pertinent portions of the Texas Public Utility Regulatory Act, Tex. Rev. Civ. Stat. Ann. art. 1446c, §§ 1-101, are reprinted as Appendices H and I.

STATEMENT OF THE CASE

This is an appeal from a Texas Supreme Court decision that affirmed certain challenged provisions in an order of the Public Utility Commission of Texas (the "PUC") setting rates for Houston Lighting & Power Company ("HL&P").[2] That order gave HL&P's ratepayers the benefits of a tax deduction for $166 million

---

[1] On motion for rehearing, the Texas Supreme Court upheld the order of the PUC against HL&P's challenge that the order violates HL&P's rights under the Fifth and Fourteenth Amendments to the United States Constitution. State ratemaking orders issued under delegated legislative authority are "state statutes" for purposes of 28 U.S.C. § 1257(2). *See, e.g., Arkansas Elec. Coop. Corp. v. Arkansas Pub. Serv. Comm'n*, 461 U.S. 375 (1983).

[2] Rate regulation sets rates at a level that allows the regulated utility an opportunity to earn revenues to pay operating expenses and to cover capital costs. That level of revenues typically is defined as:

$$\text{Revenue Requirement} = \text{Operating Expenses} + (\text{Rate Base} \times \text{Weighted Average Cost of Capital})$$

This appeal focuses on the PUC's use of tax benefits arising from costs not included in rates to reduce the amount of tax expense included in rates as an operating expense.

invested in the abandoned Allen's Creek Nuclear Project ("ACNP") even though the order specifically prevented HL&P from recovering the cost of that investment from ratepayers.

HL&P provides electric utility service to 1.3 million customers in Houston and the Gulf Coast area of Texas. In 1972, in an effort to reduce its dependence on expensive fossil fuels and to continue providing low-cost electricity to its customers, HL&P began plans for a two-unit nuclear power plant to be known as the Allen's Creek Nuclear Generating Station. By 1976, turmoil in the nation's economy and energy conservation resulting from four-fold increases in oil prices had reduced HL&P's projections of future growth in the demand for electricity. HL&P therefore decided to cancel one of the generating units in ACNP.

Over the next six years, HL&P continued to reevaluate ACNP in light of more stringent regulatory requirements for nuclear power plant construction, increases in cost estimates for other HL&P construction projects, and concern about the reliability of demand predictions. In August 1982, HL&P concluded that ACNP was no longer economically viable. It therefore abandoned plans for the remaining unit in the project. (App. 4a). By the time of the abandonment, HL&P had invested more than $361 million in engineering studies and plans, legal work, contractual commitments, and site preparation for the project. Given the project-specific nature of a nuclear plant and the preliminary stage of ACNP, HL&P's investment in the project had no significant salvage value.

When ACNP was abandoned, HL&P had pending before the PUC a request for an increase in electric rates. As part of that rate case, HL&P sought to recover from ratepayers the entire cost of the cancelled power plant project.[3] The PUC, acting on the recommendation of a

[3] When a public utility commission allows a utility to recover from ratepayers the costs of a cancelled power plant, those costs are

hearing examiner, denied full recovery. It found that HL&P should have cancelled ACNP no later than January 1, 1980, and that the $166 million spent on the project after 1979 were imprudently invested. The PUC therefore treated the $166 million investment made after 1979 as nonutility property and imposed the entire cost of that investment on HL&P and its shareholders. (App. 136a).

Having denied HL&P recovery of $166 million invested in ACNP, the PUC nevertheless reduced rates by an additional $111 million to account for the federal income tax benefit that the PUC believed HL&P would derive from taking an abandonment loss deduction for that investment. (App. 50a).[4] That rate reduction gave to the ratepayers the value of a tax benefit associated with costs expressly excluded from rate recovery. Since abandoned nuclear plants generally have no salvage value, the PUC's action effectively gave to ratepayers the entire value of nonutility property in which they invested nothing.

In a motion for rehearing before the PUC, HL&P argued that the PUC's order resulted in a confiscation of property in violation of the Texas and the United States Constitutions. HL&P also argued that the PUC had denied

---

amortized over a number of years and treated as operating expenses. *See* Rodgers and Gray, *State Commission Treatment of Nuclear Plant Cancellation Costs*, 13 Hofstra L. Rev. 443, 453 (1985); pages 7-8 *infra*.

[4] Neither the PUC's decision nor the hearing examiner's report provides any explanation for the $111 million value that the PUC assigned to the tax benefits at issue. At the 46% corporate income tax rate prevailing in 1982, a $166 million deduction could not generate a tax benefit greater than $76.4 million (*viz.*, $166 million × .46 = $76.36 million). The actual tax benefit available to HL&P from the $166 million investment was even smaller because part of the $166 million capitalized to ACNP under accounting rules represented interest expense that HL&P already had deducted under tax rules. Thus, the $111 million assigned value appears to be grossly overstated by at least $34.6 million.

HL&P due process of law by allocating a tax benefit to ratepayers without any basis in the record for either the allocation or the valuation of the benefit. The PUC summarily denied rehearing without addressing HL&P's constitutional claims. (App. 167a).

On appeal to the District Court of Travis County, HL&P argued that the PUC's order violated the Texas Public Utility Regulatory Act, the Texas Constitution, and the Fourteenth Amendment of the United States Constitution. The District Court found much of the PUC's order (including its treatment of the tax benefits) erroneous on state statutory grounds and remanded the ratemaking proceedings to the commission. (App. 38a-41a). The Court of Appeals for the Third Supreme Judicial District affirmed the District Court's decision.[5] (App. 17a).

The Texas Supreme Court reversed the Court of Appeals. Noting that the abandonment loss deduction for the disallowed investment in ACNP would lower the taxes actually paid by HL&P, the Texas Supreme Court held that all tax savings should pass to the ratepayers. (App. 8a). HL&P moved for rehearing on the grounds that the Supreme Court's decision upholding the PUC's treatment of the tax benefits resulted in a taking of property without just compensation and a denial of due process in violation of the Fifth and Fourteenth Amendments of the United States Constitution. The Texas Supreme Court summarily denied rehearing with one justice dissenting. (App. 10a).

THE QUESTIONS PRESENTED ARE SUBSTANTIAL

I. THIS CASE PRESENTS ISSUES OF NATIONAL SIGNIFICANCE.

The central question in this case is whether a state constitutionally can require the shareholders of a public utility to forfeit tax benefits from their unrecovered in-

[5] The Court of Appeals modified one conclusion not relevant to the issues now on appeal. App. 24a.

vestment in a cancelled power plant. The answer to that question has national significance.

Abrupt changes in our nation's economy have forced electric utilities throughout the country to cancel power plants in which they had invested billions of dollars. In an effort to put the burden of those abandoned projects onto the utilities' shareholders, state utility regulators often prevent utilities from including in their rates all or part of the cost of cancelled plants. The proper allocation between shareholders and ratepayers of the benefits available when part of the disallowed investment is recoverable through federal income tax deductions is a constantly recurring issue. The utility's unrecovered investment generally has no value apart from the tax benefits arising from it. If a state constitutionally can appropriate those tax benefits for ratepayers even though it has denied the utility's shareholders compensation for the use of the property that gives rise to them, then the state will have forced the shareholders to forfeit their entire investment without any compensation. Thus, the Texas Supreme Court's decision in this case has important implications for an industry in which escalating costs and new regulatory risks already have diminished the flow of investment into needed construction.

A. Plant Cancellations.

HL&P's experience with ACNP is typical of the power plant cancellations that have proliferated across the country. The late 1970s and early 1980s saw dramatic escalation in plant construction costs and substantial increases in the regulatory requirements for licensing nuclear plants.[6] At the same time, increases in fuel costs

---

[6] Between 1975 and 1980, the cost of a 1,000 megawatt coal-fired plant increased 287% and the cost of a 1,000 megawatt nuclear plant rose 345%. Energy Information Admin., U.S. Dep't of Energy, *Nuclear Plant Cancellations: Causes, Costs and Consequences* 29 (April 1983). Rapid inflation and high interest costs account for much of the increase, but several major and unexpected events had a particular effect on nuclear plants. A 1975 fire at the Tennessee

and fluctuating economic conditions led to energy conservation and decreases in the projected demand for electricity.[7] Electric utilities that had begun new power plants under the conditions of the early 1970s found many of those construction projects to be infeasible under the unexpected, new conditions of the late 1970s and early 1980s. Utilities around the country therefore began to cancel major power plant projects. Between 1977 and 1986, 56 utilities cancelled about 60 plants representing an investment of over $10 billion.[8]

The wave of major plant cancellations has put tremendous pressure on state utility regulators to depart from the accepted regulatory treatment of abandoned investments. Utility rates are the sum of two principal components: operating expenses and a return on rate base. Operating expenses include operating and maintenance expenses, depreciation, taxes, and other expenses incurred to provide utility service to the public. Rate base is a utility's undepreciated investment in the assets used to provide public service.[9] Where a cancelled plant has not gone into service, few state utility regulators have allowed utilities to earn a return on their investment in

---

Valley Authority's Browns Ferry nuclear plant and the 1979 accident at the Three Mile Island plant led to the imposition of additional licensing, design, and construction requirements that increased costs and construction time. The average interval required to complete a nuclear plant went from 6.8 years in 1971-74 to 14.4 years for plants completed in 1985. U.S. Dep't of Energy, *Energy Security—A Report to the President of the United States* 189 (March 1987).

[7] Energy Information Admin., *Nuclear Plant Cancellations, supra* note 6, at 7.

[8] *See* Edison Electric Institute, *Regulatory Treatment of Cancelled Plants: Survey and Analysis of Cases* 6-9 (1986) (hereinafter cited as *EEI Survey*); Salomon Brothers, Inc, *Stock Research: Nuclear Construction Utilities* 32-33 (February 1987).

[9] C. Phillips, *The Regulation of Public Utilities* 281 (1984).

cancelled plants by including the cost in rate base.[10] Regulators generally have permitted utilities to recover the investment itself, however, by amortizing the cost as an operating expense item.[11]

State regulators have used two techniques to reduce or mitigate the amortization allowed for the cost of cancelled plants. First, regulators allow no recovery for any part of the utility's investment in the cancelled plant that regulators find to have been imprudent.[12] Second, regulators reduce rate recovery for prudently incurred project costs by the amount of the income tax benefit that the regulators expect the utility to receive from claiming an abandonment loss deduction for those costs.[13] This allocates the tax benefits of the prudent investment to the party bearing the cost of the investment.

In its approach to the plant cancellation costs in this case, the PUC has adopted a radical practice. The commission disallowed the recovery of costs that it found to be imprudent, but it then reduced recovery of the amounts prudently incurred by allocating to ratepayers the tax

---

[10] In only about 12 of the more than 94 rate cases involving plant cancellations between 1977 and 1986 did the utility commission allow the cost of the cancelled plant to be included in rate base. *EEI Survey* at 5.

[11] In 67 of the more than 94 rate cases involving plant cancellations between 1977 and 1986, all or part of the cost of the cancelled plant was recovered as an expense. *Id.*

[12] *See, e.g., Washington Util. & Transp. Comm'n v. Pacific Power & Light Co.*, 78 P.U.R.4th 84 (Wash. Util. & Transp. Comm'n 1986); *In re Union Elec. Co.*, 74 P.U.R.4th 80 (Mo. P.S.C. 1986); *In re Maine Pub. Serv. Co.*, 67 P.U.R.4th 101 (Me. P.U.C. 1985); *In re United Illuminating Co.*, 55 P.U.R.4th 252 (Conn. Dep't of Pub. Util. Control 1983); *In re Detroit Edison Co.*, 52 P.U.R.4th 318 (Mich. P.S.C. 1983); *In re Commonwealth Elec. Co.*, 47 P.U.R.4th 229 (Mass. Dep't of Pub. Util. 1982).

[13] *See, e.g., In re Maine Pub. Serv. Co.*, 67 P.U.R.4th 101 (Me. P.U.C. 1985); *In re Central Illinois Light Co.*, 57 P.U.R.4th 351 (Ill. Commerce Comm'n 1983).

benefits associated with the *disallowed* costs.[14] This overlapping combination of the two techniques used by other regulators is a meat axe approach to cutting rates; it simply gives to ratepayers the whole benefit of property in which they invested nothing. In short, this practice gives the ratepayers lower rates than they would have paid had the utility never made the imprudent investment.

The radical practice offered to regulators by the precedent in this case requires the common shareholders of an affected utility to forfeit their unrecovered investment in a cancelled power plant. Given its scope and complexity, most of the work connected with the construction of any major power plant must be tailored to the requirements of the particular site and project. Individual design characteristics and safety requirements make nuclear power plants especially unique. A cancelled nuclear power plant like ACNP therefore has no material salvage value. The only significant value of the investment in the cancelled plant lies in the income tax benefit available from taking an abandonment loss deduction for the capital costs invested in the project.[15]

State regulators reacting to the political furor created by power plant construction already have turned capital

---

[14] Vermont's utility regulatory commission addressed a similar practice in *In re Central Vermont Pub. Serv. Corp.*, 86 P.U.R.4th 114 (Vt. P.S.C. 1987).

[15] The Internal Revenue Code specifically allows an abandonment loss deduction for the capital costs of abandoned assets. I.R.C. § 165(a); *see* Treas. Reg. § 1.165-1. The capital costs of an abandoned power plant are simply expenditures that a utility could not deduct for income tax purposes as they were incurred because they related to the construction of the capital asset. *See* I.R.C. § 263(a); Treas. Reg. § 1.263(a)-1. If the plant were completed and put into service, the capital costs would be deducted for tax purposes as depreciation expense over the life of the plant. *See* I.R.C. § 167(a). When the plant instead is abandoned, the capital costs reduced by any salvage value are deductible as a loss because the asset has lost all value to its owner.

intensive utility construction projects into high risk undertakings.[16] If a utility undertakes a large construction project in order to meet projected demand, it faces substantial political and regulatory impediments as well as the very real possibility that some of the project costs will not be recovered.[17] This hostile environment has reduced plant construction to levels that will not meet anticipated national needs. Despite the apparent need for new capacity, only 13,000 megawatts of new generating capacity are planned for 1988. Estimated new capacity in 1989 is only 8000 megawatts, and the estimate for 1990 falls to 2200 megawatts.[18]

The many legitimate impediments to needed power plant construction should not be compounded by illegiti-

---

[16] The highly-publicized political battles surrounding Long Island Lighting Company's Shoreham nuclear power plant and Public Service of New Hampshire's Seabrook nuclear plant are pointed, recent examples of this problem. The Department of Energy has noted that:

> The present climate of utility regulation in many states discourages new capital investment, and this restricts the range of new supply options that might otherwise be considered. A fundamental responsibility of a utility regulator is to balance customers' welfare with that of company stockholders; but in recent years the traditional compact in such regulation (which balanced limited risks with limited rewards) has been broken.
>
> . . . .
>
> This asymmetry in risks and rewards to utilities is caused in large part by pressure on regulators to hold down electricity rates near term.

U.S. Dep't of Energy, *Energy Security*, *supra* note 6, at 154-55.

[17] If a utility decides not to construct new generating capacity in order to avoid incurring high construction costs that it expects would be disallowed, the utility faces charges that it has abdicated its public service responsibility. *See, e.g., In re Boston Edison Co.*, Docket No. 85-266A (Mass. Dep't of Pub. Util., June 26, 1986).

[18] *Plant Construction Is Spiraling Down, Says UDI Report*, Electric Light & Power, April 1988, at 36.

mate obstacles erected by state regulators whose decisions have remained largely insulated from federal judicial review. The precedent created in this case would require utilities that undertake plant construction to risk the total loss of their investments in the projects. That new risk arises from an unconstitutional decision that merits this Court's full review.

B. The Need for Supreme Court Action.

This Court is the sole federal forum for constitutional challenges to infirmities in state ratemaking proceedings. The Johnson Act, 28 U.S.C. § 1342 (1982), effectively prevents lower federal courts from reviewing state rate orders. State courts routinely refuse to review constitutional challenges to rate orders by giving a carelessly broad interpretation to the decisions that this Court rendered decades ago in *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), and *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).[19] This Court last heard argument on a Fifth Amendment challenge to a state fixed-service rate order almost 50 years ago. *See Driscoll v. Edison Light & Power Co.*, 307 U.S. 104 (1939). State regulatory commissions therefore have operated essentially without constitutional review. *See, e.g., Dayton Power Co. v. Public Utilities Comm'n*, 4 Ohio St. 3d 91, 100, 447 N.E.2d 733, 740 (1983) ("The Constitution no longer provides any special protection for utility investors.")

This Court recently has shown an appreciation for the need to provide state utility regulators with fresh guid-

---

[19] *See, e.g., Legislative Util. Consumers' Council v. Public Serv. of N.H.*, 119 N.H. 332, 402 A.2d 626 (1979); *Cleveland Elec. Illum. Co. v. Public Util. Comm'n*, 4 Ohio St. 3d 107, 447 N.E.2d 746 (1983), *appeal denied*, 464 U.S. 802 (1983); *Savannah Elec. & Power Co. v. Public Serv. Comm'n*, 239 Ga. 156, 236 S.E.2d 87 (1977); *Washington Gas Light Co. v. Public Serv. Comm'n*, 450 A.2d 1187 (D.C. 1982); *Application of Hawaiian Tel. Co.*, 67 Haw. 370, 689 P.2d 741 (1984).

ance. Two Terms ago, the Court noted probable jurisdiction in two companion cases where utilities complained of rates so low as to be confiscatory, but a settlement mooted the cases before the Court heard argument. *Kansas Gas & Electric Co. v. State Corporation Comm'n*, 232 Kan. 483, 720 P.2d 1063 (1986), *prob. juris. noted*, 107 S. Ct. 1281, *appeal dismissed*, 107 S. Ct. 2171 (1987); *Kansas City Power & Light Co. v. State Corporation Comm'n*, 232 Kan. 483, 720 P.2d 1063 (1986), *prob. juris. noted*, 107 S. Ct. 1281, *appeal dismissed*, 107 S. Ct. 3280 (1987). This Term, the Court will hear argument in *Duquesne Light Co. v. Barasch*, No. 87-1160, on the constitutionality of a state statute that entirely excludes the cost of cancelled power plants from utility rate recovery. *Barasch v. Pennsylvania Public Utility Comm'n*, 516 Pa. 142, 532 A.2d 325 (1987), *prob. juris. noted sub nom. Duquesne Light Co. v. Barasch*, 108 S. Ct. 1105 (1988). The present case poses the related, but more fundamental question whether the value of property excluded from rate recovery nevertheless can be appropriated for the benefit of ratepayers. No matter how the Court decides the *Duquesne* case, the further question presented here will have far-reaching significance for the utility industry.

II. THE USE OF TAX BENEFITS FROM NONUTILITY PROPERTY TO REDUCE UTILITY RATES IS AN UNCONSTITUTIONAL TAKING.

The issue in this case is not whether the rates set by the PUC are adequate to compensate HL&P for property dedicated to public service. The issue is whether the PUC can reduce adequate rates in order to award ratepayers the benefit of a tax deduction associated with property not dedicated to public utility service. Thus, the standard of review found in *Federal Power Comm'n v. Hope Natural Gas Co.*, *supra*, for public utility rates challenged as inadequate under the Fifth Amendment does not apply here. *Hope* and its progeny establish that a court need

not inquire deeply into ratemaking methods if the rates set as the end result of the ratemaking proceeding provide constitutionally adequate compensation for the utility property devoted to public service. *See Hope*, 320 U.S. at 602-03. That standard of review does not apply where the state has appropriated the value of nonutility property and used it to reduce rates for the public use of utility property.

Since this case involves a taking of nonutility property rather than the reasonableness of compensation for the use of utility property, traditional Fifth Amendment principles must govern. The PUC cannot use *Hope* as a screen behind which to confiscate nonutility property. If the PUC could justify the appropriation of nonutility property by arguing that the rates nevertheless provide a reasonable return on property dedicated to public service, then the latitude given to utility regulators by *Hope* and its progeny would become a license to seize private property without just compensation.

A. HL&P's Disallowed Investment in ACNP Is Not Public Utility Property.

In this case, the PUC found that $166 million spent for ACNP were not a prudent utility investment. It disallowed any rate recovery for that investment. The PUC's decision classified the property rights attributable to the disallowed investment in ACNP, including the tax benefits, as nonutility property. The public would pay nothing for that property. Following the PUC's determination, the public had no further claim to the property. For the PUC nevertheless to appropriate all tax benefits from the property for the benefit of ratepayers is a taking of property without any compensation.

A public utility has a duty to provide adequate service to the public and a right to receive just compensation for

the service provided.[20] A utility therefore invests capital to serve the public's needs with the legitimate expectation that it will receive adequate compensation for all capital properly dedicated to the public's use.[21] Utility regulators must determine whether particular investments are reasonable and appropriately serve the public.[22] If the regulators decide that all or part of certain investments are not reasonable, they disallow the recovery from ratepayers of the inappropriate costs. The disallowance of inappropriate costs is a refusal to accept the dedication to public use of the property represented by those costs. The disallowed costs are not public utility expenditures, and the related investment is not public utility property. C. Phillips, *The Regulation of Public Utilities* 195 (1984).

Texas, like other states, recognizes the distinction between utility and nonutility property.[23] The Texas Pub-

---

[20] *See Board of Pub. Util. Comm'rs v. New York Tel. Co.*, 270 U.S. 23, 31 (1926); *see, e.g.*, Tex. Rev. Civ. Stat. Ann. art. 1446a, §§ 35(a), 39 (Vernon Supp. 1988).

[21] *See Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944); *Missouri ex rel. Southwestern Bell Tel. Co. v. Pub. Serv. Comm'n*, 262 U.S. 276, 290-91 (1923) (Brandeis, J., concurring).

[22] *See Mississippi River Fuel Corp. v. Federal Power Comm'n*, 163 F.2d 433, 437 (D.C. Cir. 1947). *See also* Phillips, *Regulation of Public Utilities, supra* note 9, at 223.

[23] *Federal Power Comm'n v. United Gas Pipe Line Co.*, 386 U.S. 237 (1967), on which the Texas Supreme Court relied in this case, also recognized the distinction between utility and nonutility property in its resolution of a statutory issue under the Natural Gas Act, 15 U.S.C. §§ 717 *et seq.* (1982). 386 U.S. at 243. *United Gas* dealt with the treatment of tax benefits from the operating losses of companies not regulated under the Act that filed consolidated tax returns with regulated companies. The tax benefits at issue were not attributes of particular capital assets, and the parties did not raise the constitutional issue presented by this case. *See also Charlottesville v. Federal Energy Regulatory Comm'n*, 774 F.2d 1205 (D.C. Cir. 1985), *cert. denied*, 475 U.S. 1108 (1986).

lic Utility Regulatory Act provides for rates that allow a public utility to recover prudently incurred operating expenses and a fair return on amounts prudently invested in property needed to render utility service. Tex. Rev. Civ. Stat. Ann. art. 1446c, § 39(a) (Vernon Supp. 1988); *see Railroad Comm'n v. High Plains Natural Gas Co.*, 628 S.W.2d 753 (Tex. 1981). Rates set under the Texas statute do not compensate a utility for property that the PUC finds not to be used and useful in the provision of public utility service. Tex. Rev. Civ. Stat. Ann. art. 1446c, § 40(a). Rates set under the statute also do not allow for the recovery of expenses incurred imprudently. *Id.* § 41(c)(3). Disallowed items are not public utility property; the utility's shareholders bear the entire cost of disallowed items. *Suburban Utility Corp. v. Public Utility Comm'n*, 652 S.W.2d 358 (Tex. 1983).

The distinction between utility and nonutility property recognized by state law responds to constitutional necessity. Under the Fifth Amendment, the public must pay for the utility property that it uses. *Permian Basin Area Rate Cases*, 390 U.S. 747, 770 (1968); *Bluefield Waterworks & Improvement Co. v. Public Service Comm'n*, 262 U.S. 679, 690 (1923). The public need not pay, however, for property that it does not use. *Acker v. United States*, 298 U.S. 426, 430-31 (1935); *West Ohio Gas Co. v. Public Utilities Comm'n*, 294 U.S. 63, 68 (1935); *see also Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Comm'n*, 262 U.S. 276, 290 n. 1 (1923) (Brandeis, J., concurring). Utility regulators operating under state law determine whether particular investments fall into one category or the other. The regulatory determination that property is utility property asserts the public's right to use that property; the determination that other property is nonutility property releases that property from the public's claims.

Where a utility commission takes the value of nonutility property in order to reduce utility rates, as the

PUC has done here, the standard of review announced in *Hope*, 320 U.S. at 602-03, cannot protect utility shareholders' constitutional rights. Since something more than utility property has been appropriated, rates that provide a fair return on utility property alone obviously are not adequate. By finding the property in question to be nonutility property, the utility commission has denied the utility any compensation for taking it.

The constitutionality of utility regulation that takes nonutility property must be tested under traditional Fifth Amendment principles. This Court applied that standard of review in *Brooks-Scanlon Co. v. Railroad Comm'n*, 251 U.S. 396 (1920). In *Brooks-Scanlon*, a state railroad commission had refused to allow a timber company to abandon an unprofitable railroad operation on the ground that the company's nonutility operations generated sufficient income for the company to make a profit notwithstanding the loss from the railroad. This Court used ordinary Fifth Amendment standards flatly to reject the view that benefits from nonutility property could be taken to reduce utility rates. *Id.* at 399.

B. The PUC Confiscated HL&P's Disallowed Investment in ACNP.

The principle that utility regulators may not take nonutility property in order to subsidize utility rates is indisputable. Indeed, American public utility regulation rests upon that bedrock understanding.[24] The question in a particular case, of course, is whether the regulatory treatment there at issue constitutes a taking. The magisterial answer to that question announced by Justice Holmes in *Brooks-Scanlon* may provide little guidance in complex modern cases, but this Court's recent Fifth Amendment decisions strongly support the conclusion

---

[24] *See, e.g., Northern Pac. Ry. v. North Dakota*, 236 U.S. 585 (1915); *Munn v. Illinois*, 94 U.S. 113 (1877).

that the PUC's action in this case unconstitutionally deprives HL&P of its property without just compensation.

Although this Court's recent Fifth Amendment decisions have been the product of "essentially ad hoc, factual inquiries," those decisions have emphasized the significance of three factors in determining whether the "economic injuries caused by public action" constitute a taking for which compensation is required. *Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1979). Those factors are (i) the character of the governmental action, (ii) the economic impact of the regulation, and (iii) the interference with reasonable investment-backed expectations. *Id.* No factor necessarily carries greater weight than another, but a single factor can be dispositive in a given case. *See, e.g., Hodel v. Irving*, 107 S. Ct. 2076, 2083 (1987) (character of governmental action dispositive); *Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1005 (1984) (interference with investment-backed expectations dispositive). The PUC's action in this case is unconstitutional under each of the three factors, and its interference with legitimate investment-backed expectations is palpable.

The character of the governmental action in this case is extraordinary. Behind the screen of a ratemaking proceeding, the PUC has seized for the public the value of property that the PUC itself expressly excluded from the scope of the proceeding. After excluding HL&P's $166 million investment from rates, the PUC nevertheless reduced rates in order to give ratepayers the $111 million value imputed to the tax attributes of the investment. "No police power justification is offered for the deprivation." *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155, 163 (1980). The PUC simply used the appropriated property to reduce rates that it had determined to be reasonable. Such a "forced contribution" to the public without any substantial justification related to the public health and safety violates the Fifth

Amendment. *Id.; see Connolly v. Pension Benefit Guaranty Corp.*, 106 S. Ct. 1018, 1027 (1986); *Armstrong v. United States*, 364 U.S. 40, 49 (1960).

The PUC's action has substantial economic impact. The PUC valued the property that it took at $111 million. More importantly, the taking is virtually complete. The possible tax benefit from deducting the abandonment loss represents virtually all of the value realizable from HL&P's $166 million investment. The PUC took that remaining value for ratepayers without compensation. A taking of such totality not closely tied to the accomplishment of a vital public purpose is unprecedented and unjustified. *See Keystone Bituminous Coal Ass'n v. DeBenedictis*, 107 S. Ct. 1232 (1987) (vital public interest in preventing surface subsidence justified taking); *Miller v. Schoene*, 276 U.S. 272 (1928) (vital public interest in arresting plant disease justified taking).

The PUC's appropriation of tax benefits from nonutility property manifestly interferes with the legitimate, investment-backed expectations of the utility shareholders who bear the entire cost of HL&P's disallowed investment in ACNP. Utility investors legitimately expect that the utility will receive compensation for property dedicated to public use. Although they take the risk, particularly in the regulatory environment of the 1980s, that certain investments may be disallowed, the investors also legitimately expect that losses from disallowances will be mitigated by certain tax benefits.

The right to claim a tax deduction for the loss of an abandoned construction project, which has been appropriated in this case, is more than a "unilateral expectation or an abstract need." *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. at 161. It is a right established by federal statute.[25] Since the availability of tax

[25] Section 165 of the Internal Revenue Code gives taxpayers the right to claim abandonment loss deductions. *See supra* note 15.

benefits to mitigate project losses directly affects an investor's decision about the desirability of the investment, the PUC's appropriation of such benefits cuts as deeply into legitimate investment-backed expectations as the governmental disclosure of trade secrets found to be unconstitutional in *Ruckelshaus v. Monsanto Co.*, 467 U.S. at 1005. Here, as in *Monsanto*, that interference by itself is serious enough to make the governmental action a violation of the Fifth Amendment.

The tax benefit appropriated by the PUC is essentially the only valuable property right recoverable from HL&P's nonutility investment in ACNP. The PUC's decision to take the benefit strips the investment of any meaningful value. Instead of a tax benefit that the PUC estimated at $111 million, the $166 million investment now can yield its owner no more than minimal salvage. In fact, by overstating the potential tax benefit,[26] the PUC's order actually appears to have appropriated more than the entire value of HLP&'s investment at the time of the taking.

State action that strips private property of all material value to its owner effects a taking of property for which compensation is required. *Ruckelshaus v. Monsanto Co.*, 467 U.S. at 1004-05 (citing *United States v. General Motors Corp.*, 323 U.S. 373, 378 (1945)). While this Court has found that state regulation may deny a property owner certain rights to the beneficial use and exploitation of his property, *see, e.g., Keystone Bituminous Coal Ass'n v. DeBenedictis*, 107 S. Ct. 1232 (1987), regulation that renders property useless to the private owner cannot be sustained unless the state provides just compensation. *See Hodel v. Irving*, 107 S. Ct. at 2084; *Agins*

Legitimate expectations created by statute are property rights entitled to protection under the Fifth and Fourteenth Amendments. *See, e.g., Mathews v. Eldridge*, 424 U.S. 319, 332 (1976); *Armstrong v. United States*, 344 U.S. 40, 44 (1960).

[26] *See supra* note 4.

v. Tiburon, 447 U.S. 255, 260-61 (1980); *Penn Central Transportation Co. v. New York*, 438 U.S. 104, 127-28 (1978). The PUC's order in this case steps well beyond the boundary drawn by the Fifth Amendment. At best, the order forces HL&P to forfeit all material value of its nonutility investment in ACNP. In fact, the order appears to take even more than the value of the investment put at issue in the case.

III. A RATEMAKING DETERMINATION MADE WITHOUT ANY BASIS IN THE RECORD IS A DENIAL OF DUE PROCESS.

This Court long has recognized that a regulatory order lacking any basis in the regulatory record is arbitrary and a denial of the due process guaranteed by the Fourteenth Amendment. *Northern Pacific Railway v. Department of Public Works*, 268 U.S. 39, 44-45 (1925); *Interstate Commerce Comm'n v. Louisville & Nashville Railroad*, 227 U.S. 88 (1913). The Due Process Clause also requires regulators to give affected parties sufficient "opportunity through evidence and argument to challenge the result" of the agency order. *Railroad Comm'n v. Pacific Gas & Electric Co.*, 302 U.S. 388, 393 (1938). Without notice and an opportunity to be heard, parties subject to regulation are deprived of a fair opportunity to protect their property from arbitrary state action. *See Fuentes v. Shevin*, 407 U.S. 67, 80-81 (1972).[27] Without a record that discloses the grounds for the regulatory decision and the essential facts upon which that decision is based, courts cannot interdict arbitrary decisions. *See Dunlop v. Bachowski*, 421 U.S. 560, 574 (1975).[28]

---

[27] *See also Federal Radio Comm'n v. Nelson Bros. Bond & Mortgage Co.*, 289 U.S. 266, 277 (1933) (a finding without substantial evidence to support it is an arbitrary or capricious finding); *The Chicago Junction Case*, 264 U.S. 258, 265 (1924) (to make an essential finding without supporting evidence is arbitrary).

[28] Both federal and state statutes have codified these constitutional requirements. *See, e.g.*, Administrative Procedure Act, 5

In this case, the PUC gave no notice of its intention to allocate to ratepayers the tax benefits associated with HL&P's disallowed investment in ACNP. The hearing examiner's report to the PUC contains no discussion of tax benefits because the issue simply was not raised or discussed in the agency hearing. Even if the PUC had some basis for allocating the tax benefits to ratepayers, the record contains no evidence about how the benefits were calculated. Indeed, whatever assumptions the PUC used to make its calculations in this case patently were wrong.[29] A manifestly incorrect decision made without any basis in the ratemaking record is arbitrary and a denial of HL&P's right to due process.

U.S.C. §§ 551 *et seq.* (1982); Texas Administrative Procedure Act, Tex. Rev. Civ. Stat. Ann. art. 6252-13a *et seq.* (Vernon Supp. 1988). This Court has held that the Federal Administrative Procedure Act creates "safeguards even narrower than the constitutional ones, against arbitrary official encroachment of private rights." *United States v. Morton Salt Co.*, 338 U.S. 632, 644 (1950).

[29] *See supra* note 4.

CONCLUSION

The Court should note probable jurisdiction and set this case for argument. In an increasingly complex utility industry, the constitutional issues posed by rate-making are difficult and important. The state regulators of electric utilities are sorely in need of guidance. This Court should reverse the Texas Supreme Court's decision and remand the case with instructions to set rates that contain no reduction for any tax benefit realizable from disallowed investment.

Respectfully submitted,

HUGH RICE KELLY
HOUSTON LIGHTING & POWER COMPANY
Post Office Box 61867
Houston, TX 77208
(713) 229-7265

ROBERT J. HEARON, JR.
GRAVES, DOUGHERTY, HEARON & MOODY
Post Office Box 98
Austin, TX 78767
(512) 480-5600

EDGAR M. ROACH, JR.*
MARY NASH K. RUSHER
HUNTON & WILLIAMS
One Hannover Square
Raleigh, NC 27601
(919) 899-3000

GREGORY EVERS MAY
HUNTON & WILLIAMS
2000 Pennsylvania Ave., N.W.
Washington, DC 20006
(202) 955-1500

Attorneys for Houston Lighting & Power Company

August 1, 1988

* Counsel of Record

(2)

Supreme Court, U.S.
FILED
AUG 1 1988
JOSEPH F. SPANIOL, JR.
CLERK

No. 88-181

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

HOUSTON LIGHTING & POWER COMPANY,
Appellant,

v.

PUBLIC UTILITY COMMISSION OF TEXAS,
Appellee.

On Appeal from the Supreme Court of Texas

APPELLANT'S APPENDIX TO JURISDICTIONAL STATEMENT

HUGH RICE KELLY
HOUSTON LIGHTING & POWER COMPANY
Post Office Box 61867
Houston, TX 77208
(713) 229-7265

ROBERT J. HEARON, JR.
GRAVES, DOUGHERTY, HEARON & MOODY
Post Office Box 98
Austin, TX 78767
(512) 480-5600

EDGAR M. ROACH, JR.*
MARY NASH K. RUSHER
HUNTON & WILLIAMS
One Hannover Square
Raleigh, NC 27601
(919) 899-3000

GREGORY MAY
HUNTON & WILLIAMS
2000 Pennsylvania Ave., N.W.
Washington, DC 20006
(202) 955-1500

Attorneys for Houston Lighting & Power Company

* Counsel of Record

August 2, 1988

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

F/O

TABLE OF CONTENTS

	Page
Appendix A—Judgment and Opinion of the Texas Supreme Court (December 16, 1987)	1a
Appendix B—Order Denying Rehearing by the Texas Supreme Court, with Dissent (May 4, 1988)	10a
Appendix C—Judgment and Opinion of the Court of Appeals of Texas at Austin (July 2, 1986)	15a
Appendix D—Final Judgment of the District Court of Travis County (September 13, 1984)	37a
Appendix E—Final Order of the Public Utility Commission of Texas, together with Examiner's Report, Docket No. 4540 (December 6, 1982)	44a
Appendix F—Order of the Public Utility Commission of Texas Denying Rehearing (December 31, 1982)	167a
Appendix G—Notice of Appeal (July 21, 1988)	170a
Appendix H—Excerpts from the Texas Public Utility Regulatory Act as in Effect Before September 1, 1983	172a
Appendix I—Excerpts from the Texas Public Utility Regulatory Act as Effective September 1, 1983	177a

APPENDIX A

Judgment and Opinion of the Texas Supreme Court

IN THE SUPREME COURT OF TEXAS

No. C-5705

PUBLIC UTILITY COMMISSION OF TEXAS

v.

HOUSTON LIGHTING & POWER COMPANY, *et al.*

From Travis County
Third District

JUDGMENT

This cause was heard on writ of error from the Court of Appeals for the Third District. The original transcript and the transcript showing the proceedings in the Court of Appeals were considered.

It is the opinion of the Court (Justice Raul A. Gonzalez, author) there is error in part of the judgment of the court of appeals which affirmed the trial court in all respects, except that it deleted the trial court's conclusion that the PUC's finding of HL&P's mismanagement was "premature and presumptious". The trial court reversed the PUC's order which dealt with imposition of a penalty, recovery of cancellation costs, treatment of tax benefits, allocation of litigation expenses and assertion of rate discrimination and remanded the case to the PUC.

In accordance with the opinion of this court, it is ordered that:

1) Judgment is rendered that:

   a. tax savings generated from HL&P's imprudent expenses inure to the benefit of the ratepayer.

   b. a utility's rates must reflect the tax liability actually incurred, and

   c. the PUC will refrain from allocating costs of litigation and recoveries from the STNP litigation until such time as the actual amounts of said costs and recoveries can be determined.

2) That part of the judgment of the court of appeals which

   a. allocated tax benefits associated with the disallowed ACNP cost to HL&P and its shareholders, and

   b. allocated the STNP related litigation costs and recoveries

   is reversed.

3) That part of the judgment of the court of appeals which affirmed the trial court's judgment that remanded the cause to the Public Utility Commission as to Dow Chemical's assertions of rate discrimination is affirmed.

4) The remainder of the court of appeals judgment is affirmed.

5) The cause is remanded to the Public Utilities Commission also to allocate the STNP litigation costs and recoveries when determined.

6) Public Utilities Commission and HP&L shall each pay one-half the costs in this court.

A copy of this judgment with a copy of the opinion shall be certified to the District Court of Travis County for observance.

(Opinion by Justice Gonzalez)

IN THE SUPREME COURT OF TEXAS

No. C-5705

PUBLIC UTILITY COMMISSION OF TEXAS

v.

HOUSTON LIGHTING & POWER COMPANY, *et al.*

From Travis County
Third District

OPINION

This cause is an administrative appeal addressing the scope of authority of the Public Utility Commission (PUC) to allocate costs, profits and tax benefits between ratepayers and shareholders. Houston Lighting & Power Co. (HL&P) applied to the PUC for a rate increase. After a hearing, the final order of the PUC provided that a 16.85% return on equity was reasonable. However, the PUC penalized HL&P .5% for alleged imprudent management of two nuclear power projects—the Allen's Creek Nuclear Project (ACNP) and the South Texas Nuclear Project (STNP). The PUC also held that the ACNP should have been cancelled on January 1, 1980 and that all expenditures on the project after this date were disallowed and not recoverable from the ratepayers.

On appeal by HL&P, the trial court reversed the order of the PUC on the grounds that the PUC had no statutory authority to impose a penalty on a utility's rate of return. The trial court also reversed and remanded the PUC's order as it related to the recovery of ACNP cancellation costs, the treatment of tax benefits associated with $166 million in disallowed ACNP expenditures and

the allocation of litigation expenses attributable to a suit between HL&P and Brown & Root involving the STNP. The trial court also remanded to the PUC for specific findings regarding Dow Chemical Company's assertions of rate discrimination by HL&P.

The court of appeals affirmed the judgment of the trial court in all respects, except that it deleted the trial court's conclusion that the PUC's finding of HL&P's mismanagement was "premature and presumptuous." 715 S.W.2d 98. We reverse and render in part the judgment of the court of appeals and affirm in part.

Facts

Plans for ACNP were initiated by HL&P in August of 1972, as a two-unit 2400 megawatt plant. However, in September of 1975, HL&P considered cancelling ACNP because its electric demand forecasts had been overly optimistic. While HL&P evaluated the future of ACNP, all activity on the project was suspended. HL&P eventually announced plans in late 1976 to cancel one of the 1200 megawatt units. Construction then resumed on the other unit.

From 1976 to 1979, three additional factors emerged which made continued expenditures by HL&P for the development of ACNP more venturesome: (1) The capital costs for nuclear plants escalated more rapidly than comparable costs for coal powered generation, (2) the safety regulations which governed the construction of ACNP increased substantially due to the Three Mile Island incident and (3) the licensing process for ACNP became stalled in 1979 because of construction difficulties.

Despite these obstacles, it was not until early 1981 that HL&P renewed consideration about cancelling ACNP. The project was ultimately cancelled by HL&P on August 26, 1982 at a total loss of $361 million. In 1982 HL&P filed with the PUC an application for a rate increase.

After considering all of the evidence in the record, the PUC set the rate of return at 16.35% (after the .5% penalty) and concluded that a prudent utility would have cancelled ACNP as of January 1, 1980. As a result, all ACNP related expenses incurred *after* January 1, 1980, in the amount of $166 million, were, by definition, imprudent. All ACNP related expenses incurred *prior* to January 1, 1980, in the amount of $195 million dollars, were prudent. The final order of the PUC provided that these prudently incurred expenses could be recovered by HL&P from its ratepayers through a ten year amortization plan. By the end of ten years, HL&P would recoup all of the $195 million as cost of service revenues. In addition, the amount paid by HL&P in income taxes on those revenues would be recovered in the rate structure.

The PUC recognized that HL&P intended to write-off for tax purposes, the $166 million of imprudent ACNP expenditures. The effect of such a write-off would provide tax savings to HL&P and cause it to bear less than its $166 million share of ACNP. In order to give effect to its ruling that HL&P bear the full burden of these imprudent expenses, the PUC determined that any tax savings derived from a write-off should inure to the benefit of the ratepayers.

HL&P argues that it should be allowed to retain all tax savings associated with the tax write-off of the $166 million. Under HL&P's proposal, its actual tax liability would be reduced by the savings attributed to the tax write-off of the disallowed expenses. However, for ratemaking purposes, HL&P's cost of service would not reflect these tax savings in the federal income tax allowance. Thus, HL&P's cost of service would be overstated by the amount that HL&P saves as a result of its tax write-off. In turn, the federal income tax expense passed on to the ratepayers would not be reduced to reflect HL&P's tax savings. The result is that the ratepayers

of HL&P would be required to pay an amount for federal income tax expense in excess of that actually borne by the utility. This additional income tax expense is the benefit that HL&P seeks to retain.

Recovery of Operating Expenses

It is generally recognized that the establishment of just and reasonable rates requires consideration of three factors: (1) the utility's reasonable and prudent operating expenses; (2) the rate base; and (3) a reasonable rate of return. *Railroad Commission of Texas v. Entex, Inc.*, 599 S.W.2d 292, 294 (Tex. 1980); *Railroad Commission of Texas v. Houston Natural Gas Co.*, 289 S.W. 2d 559, 573 (Tex. 1956); *Tex. Rev. Civ. Stat. Ann. art.* 1446c, § 39. Included in reasonable and prudent operating expenses are all taxes incurred by the utility, including federal income taxes. 16 *Tex. Admin. Code* § 23.21 (b)(1)(D); *Suburban Utility Corp. v. Public Utility Commission*, 652 S.W.2d 358 (Tex. 1983); *see also Galveston Electric Co. v. City of Galveston*, 258 U.S. 388, 42 S.Ct. 351 (1922).

In the ratemaking process, the amount of a utility's operating expenses has a direct effect upon the calculation of its rate. When a utility can demonstrate an increased level of reasonable and prudent operating expenses, its rate will be raised. To insure that its rate is just and reasonable, a utility must prove that all operating expenses have been actually incurred. *Suburban Utility Corp., see also Federal Power Commission v. United States Pipeline Co.*, 386 U.S. 237, 87 S. Ct. 1003 (1967).[1]

---

[1] In *United States Pipeline Co.*, a utility was a member of an affiliated group of companies which had filed consolidated income tax returns. The total consolidated tax expense was less than the total tax expense if separate returns had been filed. For ratemaking purposes, the utility wanted its own tax expense to be based upon the amount that it would have paid if it had filed a separate return. The Commission refused to calculate a rate

Not all expenses that are incurred by a utility in providing service will necessarily be categorized as reasonable operating expenses for ratemaking purposes. Texas regulatory agencies possess the discretionary authority to disallow those operating expenses which are not prudently or actually incurred by a utility. *Tex. Rev. Civ. Stat. Ann. art.* 1446c. § 41(c)(3). Such expenses are considered to be improper and may not be used in the calculation of the utility's new rate. If improper expenses are disallowed from the rate structure, the shareholders of the utility absorb them rather than the ratepayers. *See Suburban Utility Corp.*; *see generally E. Gelhorn & R. Pierce, Jr., Regulated Industries* 97 (1982).

In this case the PUC asserts that the court of appeals erred as a matter of law by allocating the tax savings attributable to HL&P's write-off of the ACNP disallowed expenses to the utility and its shareholders rather than to the ratepayers. The issue before this court then is whether HL&P can recover from ratepayers a federal income tax expense which it did not incur. The resolution of this issue does not rest upon a determination of whether the disallowed expenses which generated the tax savings have been included in the calculation of the new rate. The question is whether HL&P actually incurred this tax expense.

Allocation of Tax Savings from Disallowed Expenses

In *Suburban Utility Corp.*, a utility which operated as a Subchapter S corporation sought to have the federal income tax expense that it would have been required to

---

of return by converting a hypothetical tax payment into a reasonable operating expense. It ordered the utility's tax expense to be based upon the consolidated taxes it had actually paid.

The Supreme Court upheld the ruling of the Commission. It reasoned that if rates were established as proposed by the utility, the utility and its shareholders would receive the fair return to which they were entitled plus the full amount of an expense never in fact incurred.

pay as a conventional corporation included in its cost of service as a reasonable and prudent operating expense to be recovered from its ratepayers. Under the Internal Revenue Code, this Subchapter S corporation did not pay any federal income tax because all of its profits were paid directly to its two shareholders. The shareholders in turn paid taxes on the profits as ordinary income. The PUC refused to include the higher tax expense in the utility's cost of service on the basis that a tax expense which has not been actually incurred by a utility should not be recovered from its ratepayers.

On appeal this court followed the reasoning set forth by the United States Supreme Court in *United States Pipeline Co.*, 386 U.S. at 237, and held that the utility was entitled to a just and reasonable rate which was based upon only the tax expense that had been actually incurred or the tax expense the utility would have incurred as a conventional corporation, whichever is less. Accordingly, *Suburban Utility Corp.*, requires that ratepayers not be held accountable for more than the actual tax expense of a utility. *See also Southern Union Gas Co. v. Railroad Commission of Texas*, 701 S.W.2d 277 (Tex. App.—Austin 1985, writ ref'd n.r.e.) in which hypothetical income tax liability was not permitted to be included in the utility's cost of service.

Thus, ratepayers can be held accountable only for those tax expenses that are *actually* incurred by a utility. Accordingly, when a utility claims federal income tax deductions for *all* of the expenses it has incurred, the resulting tax savings will necessarily reduce the utility's actual federal income tax expense. This will be the effect regardless of whether the expenses are allowed or disallowed in the calculation of a new rate.

Consequently, we hold that the tax savings generated from HL&P's imprudent expenses should inure to the benefit of the ratepayers. The utility's rates must reflect the tax liability actually incurred.

The STNP Litigation

Next we turn to the question of allocating any costs and recoveries that may arise out of the STNP litigation. It is undisputed that at the time of the PUC's decision, the STNP litigation was still pending. Therefore, the PUC's, the trial court's and the court of appeals' decisions concerning allocation of the litigation costs and recoveries were premature and advisory. A court has no jurisdiction to render an advisory opinion on a controversy that is not yet ripe. *California Products, Inc. v. Puretex Lemon Juice, Inc.*, 334 S.W.2d 780, 782 (1960); *Morrow v. Corbin*, 62 S.W.2d 641, 646 (Tex. 1933). A determination of the proper allocation of litigation costs and recoveries should be made only after resolution of the litigation. Therefore, the PUC will refrain from deciding this issue until such time as the actual amounts of the litigation costs and recoveries are determined.

That part of the court of appeals judgment allocating the tax benefits associated with the disallowed ACNP costs to HL&P and its shareholders is reversed and rendered. The part of the judgment allocating the STNP related litigation costs and recoveries, if any, is reversed and remanded. In all other respects, the judgment of the court of appeals is affirmed. The cause is remanded to the PUC for further consideration consistent with this opinion.

/s/ Raul A. Gonzalez
RAUL A. GONZALEZ
Justice

Opinion Delivered: December 16, 1987

APPENDIX B

Order Denying Rehearing by the Texas Supreme Court, with Dissent

---

SUPREME COURT OF TEXAS
P.O. Box 12248
Supreme Court Building
Austin, Texas 78711
Mary M. Wakefield, Clerk

May 4, 1988

Ms. Carole J. Vogel
Ms. Karen Pettigrew
Office of the Attorney General
P. O. Box 12548
Austin TX 78711

Mr. Hugh Rice Kelly
Mr. G. Schalles, III &
Mr. H. Leven
Houston Lighting &
Power Company
P. O. Box 61867
Houston TX 77208

Mr. Robert J. Hearon, Jr.
Graves, Dougherty, Hearon
& Moody
2300 InterFirst Tower
Austin TX 78701

Mr. Finis Cowan, Jr.
Baker & Botts
3000 One Shell Plaza
Houston TX 77002

Mr. Jefferson D. Giller
Fulbright & Jaworski
5100 Gulf Tower
1301 McKinney Street
Houston TX 77002

Mr. Lee C. Clyburn
Fulbright & Jaworski
2400 One American Center
600 Congress Avenue
Austin TX 78701

RE: Case No. C-5705

STYLE: PUBLIC UTILITY COMMISSION OF TEXAS v. HOUSTON LIGHTING AND POWER COMPANY *et al.*
No. 343,112 in the 201st District Court, Travis County
No. 14,354 in the Third Court of Appeals

Dear Counsel:

Today, the Supreme Court of Texas overruled the motion for rehearing on behalf of Public Utility Commission

and the motion for rehearing, as supplemented, on behalf of Houston Lighting and Power Company in the above referenced cause with the enclosed Dissenting Opinion on Rehearing by Justice Wallace (Chief Justice Phillips and Justice Culver not sitting).

Respectfully yours,

MARY M. WAKEFIELD
Clerk

By /s/ Peggy Littlefield
PEGGY LITTLEFIELD
Chief Deputy Clerk

cc. Mr. John Dickson
District Clerk
Travis County Courthouse
P. O. Box 1748
Austin TX 78767

Hon. Herman Jones
District Judge
3303 Greenlee
Austin TX 78703

Hon. James L. Carroll
Justice, Third Court of Appeals
P.O. Box 12547
Austin TX 78711

IN THE SUPREME COURT OF TEXAS

No. C-5705

PUBLIC UTILITY COMMISSION OF TEXAS,
Petitioner,

v.

HOUSTON LIGHTING & POWER COMPANY, *et al.*,
Respondent.

From Travis County Third District

ON MOTION FOR REHEARING
DISSENTING OPINION

In this rate hearing, the Public Utility Commission disallowed $166,000,000 for the cost expended by Houston Lighting & Power in preparation for building the Allen Creek Nuclear Plant. The effect of the Public Utility Commission's order was to declare that the $166,000,000 was not expended for utility purposes.

Houston Lighting & Power, Inc., is a wholly owned subsidiary of Houston Industries, Inc., which consists of business operations other than public utilities. The effect of the Public Utility Commission order disallowing $166,000,000 cost was to transfer that cost item from Houston Lighting & Power to the shareholders of Houston Industries, Inc. Thus, the $166,000,000 was no longer a factor in determining Houston Lighting & Power Company's rate base.

Public Utility Commission's Substantive Rule § 23.2(2)(B)(I), codified at 16 T.A.C. § 23.2, requires all large utilities to maintain their books and records in accordance with Federal Energy Regulatory Rules. The FERC rules require separate allocation of utility and non-utility financial data. This is to assure that only those costs reason-

ably necessary in providing utility service to the customers will be included in the utility rate base. If the utility is a component of an entity with other business interests, as is the case with Houston Lighting & Power, it may not use utility rates to subsidize those other activities.

The cost of utility services includes Federal Income Tax on the taxable revenues and the tax deductible expenses incurred in providing service. PURA § 41 (c) (2), and PUC Substantive Rule § 23.21 (b) (1) (d). When a corporation such as Houston Industries, Inc., and Houston Lighting & Power produce taxable revenues and deductible expenses they must be segregated on the basis of whether they are attributable to utility service or non-utility service.

FERC regulations provide that if expenses which generate tax deductions are included in the cost of service, the deduction will reduce the cost of service for rate making purposes. Columbia Gulf Transmission Co., 23 FERC (CCA) ¶ 61.396 (June 22, 1983). In the case before us, the PUC disallowed the $166,000,000 for rate making purposes, so the rate payers will not bear that expense. Therefore, they are not entitled to the benefit of the deduction. The deductions go to the party who bears the expense, which in this case would be the shareholders of Houston Industries, Inc. This is the standard procedure consistently used by the Public Utilities Commission, but rejected by it in this case.

The PUC's action in this case could result in a substantial cost to Houston Lighting & Power rate payers. The Internal Revenue Code provides accelerated depreciation on certain items of equipment and machinery to integrated companies which comply with FERC regulations. However, the Code requires that deduction permitted must go to the entity incurring the costs, *i.e.*, utility rated versus non-utility rated. I.R.C. § 167(1) (3) (G), 168(i) (9) (West Supp. 1988); *see* 1 Fed. Tax Reg. §§ 1.167(1)-

1(h), 1.167(a)-11(b)(6), 1.167(1)-1 (West 1988). If this is not done, then all the depreciation must be on a straight line basis. This means that not only the non-utility operations of Houston Industries, Inc., but also Houston Lighting & Power could lose the substantial advantage gained on accelerated depreciation. Should this occur, then Houston Lighting & Power would be entitled to an increase in rates so as to make a reasonable rate of return on its investment.

Our opinion in this case relied on the "taxes actually paid by its shareholders" language used by this court in *Suburban Utility Corp. v. Public Utility Commission of Texas*, 652 S.W.2d 358 (Tex. 1983). That case was considered in an altogether different context. There, this court held that the tax actually paid by the shareholders should be included in the utility rate base because it was a Subchapter S corporation which passed all revenue on to the shareholders who individually paid taxes. The utility paid no income tax. Here, the utility pays its own taxes, so the corollary should be that the taxes paid (or deductions claimed) by the utility should be credited to the rate payer. This is not authority for the rate payer to be given credit for tax deductions earned by expenses paid by the shareholders.

To permit the PUC to disallow $166,000,000 as non-utility related expenses and then to deny the shareholders who must bear those expenses any tax deductions arising from that expense is tantamount to permitting the Public Utility Commission to fine the shareholders for poor management. The majority expressly holds that the PUC has no authority to do so. I would reverse that part of the court of appeals' judgment which decrees that any tax benefits resulting from the $166,000,000 expense must be passed through to the rate payers.

JAMES P. WALLACE
Justice

Opinion Delivered: May 4, 1988.

APPENDIX C

Judgment and Opinion of the Court of Appeals of Texas at Austin

---

IN THE COURT OF APPEALS
THIRD SUPREME JUDICIAL DISTRICT OF TEXAS
AT AUSTIN

14,354

JUDGMENT RENDERED JULY 2, 1986

PUBLIC UTILITY COMMISSION OF TEXAS

v.

HOUSTON LIGHTING AND POWER COMPANY, *et al.*

Appeal from 201st District Court of Travis County

Before Chief Justice Shannon, Justices Gammage and Carroll

MODIFIED AND, AS MODIFIED, AFFIRMED—Opinion by Justice Carroll

THIS CAUSE came on to be heard on the transcript of the record of the court below, and the same being considered, because it is the opinion of the Court that there was error in that court's judgment, but that such error

does not require the judgment be reversed: IT IS THEREFORE considered, adjudged and ordered that the judgment of the trial court be and is hereby modified to delete conclusion number seven, in accordance with the opinion of this Court. As so modified herein, the judgment of the trial court is affirmed. It is FURTHER ordered that appellant, Public Utility Commission of Texas, pay all costs in this behalf expended, and that this decision be certified below for observance.

IN THE COURT OF APPEALS
THIRD SUPREME JUDICIAL DISTRICT OF TEXAS
AT AUSTIN

ON MOTION FOR REHEARING

No. 14,354

PUBLIC UTILITY COMMISSION OF TEXAS,
Appellant

vs.

HOUSTON LIGHTING AND POWER COMPANY, *et al.*,
Appellees

From the District Court of Travis County,
201st Judicial District
No. 343,112

HONORABLE HERMAN JONES, Judge

The prior opinion of this Court is withdrawn and the following is substituted therefore.

The Public Utility Commission appeals from a district court judgment reversing and remanding portions of a Commission rate order. The Commission also appeals from an order of the district court remanding a portion of the rate order as it pertains to Dow Chemical Company's assertions of rate discrimination. Houston Lighting & Power and Dow are appellees. We will modify and affirm the judgment of the district court.

THE CONTROVERSY

This cause is an administrative appeal of the Commission's order in response to an application by HL&P for a rate increase in 1982. After a two month hearing,

the Commission concluded that a 16.85% return on equity was reasonable for HL&P. As set forth in the Commission's final order, this return was reasonable only under circumstances of efficient management. Because the Commission found that HL&P management acted imprudently on numerous occasions, it penalized HL&P by lowering its return on equity from 16.85% to 16.35%. Most of the testimony in the rate hearing focused on HL&P's participation in two nuclear power ventures: the Allen's Creek Nuclear Project (ACNP) and the South Texas Nuclear Project (STNP). Broadly summarized, the Commission found that HL&P was responsible for numerous delays and cost overruns in the construction of the STNP venture, and was imprudent in not cancelling the ACNP venture by January 1, 1980. These conclusions form the basis for imposing the rate penalty.

The district court concluded that the Commission had no statutory authority to impose a penalty on a utility's rate of return. The district court also rendered judgment overruling portions of the Commission's order as it related to the recovery of ACNP cancellation costs, the treatment of tax benefits associated with $166 million in disallowed ACNP expenditures, and the allocation of the the Brown & Root litigation expenses and any potential recovery by HL&P in that lawsuit. Finally, the district court remanded a portion of the cause to the Commission for specific findings as to rate discrimination against Dow. In all other respects, the Commission's final order was affirmed.

The Commission contends that the district court erred: (1) in holding that the Commission could not reduce a public utility's return on equity as a penalty for mismanagement; (2) in remanding the cause to the Commission so that HL&P could develop and potentially recover ACNP cancellation costs; (3) in its allocation of tax benefits arising from the cancellation of the ACNP; (4) in its allocation of Brown & Root litigation expenses and any potential recovery; and (5) in remanding the

Dow portion of the appeal to the Commission for specific findings on rate discrimination.

THE RATE PENALTY

In its first point of error, the Commission attacks the district court's conclusion that no statutory authority exists for penalizing a utility for mismanagement by reducing its rate of return on equity. The Commission argues that the Public Utility Regulatory Act (PURA) impliedly authorizes the Commission to impose rate penalties for poor management. *See generally* 1975 Tex. Gen. Laws, ch. 721, §§ 1-92, at 2327, as amended to 1982.[1] PURA §§ 39 and 40 provide the Commisison with a set of guidelines for computing a reasonable rate of return for a utility. These provisions direct the Commission to function as a substitute for competitive market forces. The Commission stresses that in a competitive market, a poorly managed company typically realizes a lower profit. The Commission contends that it must have the authority to create this result artificially by imposing rate penalties.

A district court may overturn a Commission order that exceeds the Commission's statutory authority and prejudices substantial rights of the utility. Gage v. Railroad Com'n of Texas, 582 S.W.2d 410 (Tex. 1979). Moreover, Texas courts are reluctant to imply authority in administrative agencies. Railroad Com'n of Texas v. Atchison, Topeka and Santa Fe Railroad, 609 S.W.2d 641 (Tex. Civ. App. 1980, writ ref'd n.r.e.). To determine whether agency action exceeds its statutory authority, we must compare the claimed excessive action with the pertinent statutory authority. Railroad Com'n of Texas v. Graford Oil Corp., 557 S.W.2d 946 (Tex. 1977).

---

[1] PURA is found at Tex. Rev. Civ. Stat. Ann. art. 1446c, §§ 1-92 (Supp. 1986). PURA was amended in 1983 and 1985. At oral argument and in their briefs, the parties chose to refer to sections of PURA "in effect in 1982," rather than using the Tex. Gen. Laws citation form for statutes since amended. For purposes of clarity, we will refer to sections of PURA as amended to 1982.

Pertinent to our inquiry are §§ 39 and 40(a) of PURA which in 1982 provided:

> Sec. 39. In fixing the rates of a public utility the regulatory authority shall fix its overall revenues at a level which will permit such utility to recover its operating expenses together with a *reasonable return on its investment.* (Emphasis added).
>
> Sec. 40(a). The regulatory authority shall not prescribe any rate which will yield more than a fair return upon the adjusted value of the invested capital used and useful and rendering service to the public.

At the outset, we agree that managerial competence and efficiency may be valid factors in the computation of a rate of return. A recent amendment to § 39 of PURA expressly provides that the Commission may now consider efficiency and competence in its computations. Nonetheless, the question remains whether §§ 39 and 40(a) grant the Commission authority to *lower* a rate of return it expressly finds to be reasonable, as a penalty for mismanagement.

The Commission argues that its authority is not limited by the express language in PURA. Indeed, as a general rule, administrative agencies are creatures of the Legislature and possess those powers expressly granted to them by statute, together with those necessarily implied from the authority conferred. Stauffer v. City of San Antonio, 344 S.W.2d 158 (Tex. 1961).

In support of this proposition for the instant appeal, the Commission relies on City of El Paso v. P.U.C. of Texas, 609 S.W.2d 574 (Tex. Civ. App. 1980, no writ). In that case, the City of El Paso challenged the Commission's grant of a "Capital Transition Allowance" to a utility because PURA did not expressly provide for such an allowance. The Court determined that the "Commission clearly had the power to grant the Capital Transition Allowance as it merely provides a return on certain construction work in progress. . . ." City of El Paso, 609 S.W.2d at 577.

The holding in *City of El Paso* provides no authority for assessing a rate of return penalty. The "Capital Transition Allowance" was in effect a part of the reasonable rate of return, separately calculated by the Commission. Although §§ 39 and 40 do not provide for such an allowance, the court had no difficulty in concluding that the Commission had the power to express a part of a reasonable rate of return in this fashion. Indeed, this power is *necessarily implied* from the Commission's general rate making authority. *See* Southern Pacific Transportation Co. v. Railroad Com'n of Texas, 592 S.W.2d 74 (Tex. Civ. App. 1979, writ ref'd n.r.e.).

Moreover, we can not reasonably equate the situation presented in *City of El Paso* with the instant cause. The power to permit an allowance differs vastly from the immense penalty power the Commission now claims. Although the amended PURA *now* provides that managerial competence and efficiency may be valid factors in *computing* a reasonable rate of return, there is no language in § 39, § 40 or any other section in PURA which would provide support for levying a rate penalty. As a result, we cannot necessarily imply from §§ 39 and 40(a) authority to impose a rate penalty for utility mismanagement.

The Commission also argues that Railroad Commission v. Entex, Inc., 599 S.W.2d 292 (Tex. 1980) offers support for imposing a rate penalty. In that case, the court noted many factors that might be properly considered when setting a reasonable rate of return. The Commission particularly directs our attention to "the need to provide an incentive for exploration or increased reserves." *Id.* at 295. This language represents nothing more than one factor the Railroad Commission might consider in determining a rate of return. We cannot fairly and reasonably treat the recognition of one factor that might be considered in determining a rate of return as authority for implying a power to impose a penalty.

Admittedly, some jurisdictions allow the imposition of a rate penalty on a public utility. *See* State of North

Carolina ex. rel. Utilities Commission v. General Telephone of the Southeast, 208 S.E.2d 681, 285 N.C. 671 (1974); Re General Telephone of California, 37 Pub. Util. Rep. 4th 127 (Cal. PUC, 1980). These and other cases cited by the Commission are readily distinguishable. They focus on a utility's failure to provide adequate service to ratepayers over an extended period, which is used to justify the imposition of a rate penalty. In the instant appeal, there are no findings of poor service to ratepayers.

The violations and enforcement provisions of PURA further illustrate that no implied authorization exists for imposing a rate penalty. *See* Tex. Rev. Civ. Stat. Ann. art. 1446c, §§ 71-77 (1980 and as amended to 1982). These sections provide for the imposition of fines for violations of PURA, Commission rules, regulations or orders. The Commission must first petition the Attorney General to invoke these measures. The Attorney General then brings an action on behalf of the Commission in district court against the utility. The fines imposed range from $1,000 to $5,000 for a violation. After review of the detailed procedural structure of the violations and enforcement provisions of PURA, it would be unreasonable to conclude that PURA also impliedly authorizes the Commission to levy a multi-million dollar rate penalty. Moreover, it is settled that one "is not to be subjected to a penalty unless the words of the statute plainly impose it." Commissioner v. Acker, 361 U.S. 87, 91 (1959).

There are other means at the Commission's disposal for combating imprudent utility management. Central to the Commission's argument are contentions that HL&P management failures produced additional costs and expenses. The Commission's rate making power includes the discretion to disallow improper expenses. Tex. Rev. Civ. Stat. Ann. art. 1446c, § 41(c)(3) (1980 and as amended to 1982); Suburban Utility Corp. v. P.U.C. of Texas, 652 S.W.2d 358 (Tex. 1983). In fact, the Commission exercised this authority when it disallowed expenses incurred by HL&P in ACNP after January 1, 1980 (the date the

Commission found a prudent utility would have cancelled the project). The PURA further provides that rate structures are to be "just and reasonable." Tex. Rev. Civ. Stat. Ann. art. 1446c, § 38 (1980 and as amended to 1982). This broad standard gives the Commission discretion to consider factors beyond costs and adjusted values of property in determining a reasonable rate of return on equity in a rate proceeding. Texas Alarm and Signal Association v. PUC of Texas, 603 S.W.2d 766 (Tex. 1980). As mentioned above, a recent amendment to PURA also allows the Commission to consider managerial efficiency in setting the rate of return.

This court has concluded that the Commission's reduction of a rate of return found by it to be reasonable, as a penalty for mismanagement, exceeds the Commission's authority under PURA and substantially prejudices the rights of HL&P by depriving it of revenues. In this contention, we observe that no objective standard exists for imposing a rate penalty. The Commission concedes that the .5% penalty is without support in the record. Beyond the general findings of poor management and unreasonable expenses, there is no stated basis for lowering the rate of return by .5%, as opposed to .3% or .7%. The Commission's first point of error is overruled.

Points of error two, three, and four attack the district court's conclusion that the Commission's findings regarding HL&P's mismanagement were "premature and presumptuous." The Commission contends that this conclusion exceeds the trial court's scope of review and constitutes an abuse of discretion.

In reviewing agency orders, a court is limited to consideration of whether the agency's findings and decisions are:

(1) in violation of constitutional or statutory provisions;

(2) in excess of the statutory authority of the agency;

(3) made upon unlawful procedure;

(4) affected by other error of law;

(5) not reasonably supported by substantial evidence in view of the reliable and probative evidence in the record as a whole; or

(6) arbitrary or capricious or characterized by abuse of discretion or clearly unwarranted exercise of discretion.

Tex. Rev. Civ. Stat. Ann. art. 6252-13a, § 19(e) (Supp. 1986). Moreover, it is well settled that the court does not substitute its judgment for that of the administrative agency. Imperial American Resources Fund, Inc. v. Railroad Com'n of Texas, 557 S.W.2d 280 (Tex. 1977).

We hold that the district court did not comply with the above standards in making its "premature and presumptuous" conclusion and was in effect, substituting its judgment for that of the Commission. The "premature and presumptious" conclusion exceeds the limitations imposed by § 19(e). Nonetheless, a district court may properly determine whether an agency's action is within the powers delegated to that agency. Gage v. Railroad Com'n of Texas, *supra*. We have held that the Commission exceeded its authority in assessing the rate penalty. To the extent that this conclusion relates to the rate penalty issue, the error of the district court was not such error reasonably calculated to cause and probably did cause the rendition of an improper judgment. Tex. R. Civ. P. Ann. 434 (1985). The Commission's third, fourth and fifth points of error are overruled. Nonetheless, because this conclusion is the basis for the district court's order prohibiting the Commission from using its findings regarding HL&P management of STNP, we modify the district court's final judgment to delete conclusion number seven.

ACNP CANCELLATION COSTS AND TAX BENEFITS

The Commission argues that the district court abused its discretion when it remanded this cause to the Com-

mission on the issue of ACNP cancellation costs. The Commission's final order determined that ACNP should have been cancelled on January 1, 1980. All costs incurred by HL&P before this date were deemed prudent and recoverable from the ratepayers over a ten year amortization period. Expenditures on the project after this date were not recoverable from the ratepayers. HL&P actually cancelled ACNP on August 26, 1982. Because of the cut-off date imposed by the Commission, cancellation costs at that time were disallowed. In its motion for rehearing to the Commission, HL&P requested that it be allowed to present evidence of cancellation costs it would have incurred had it cancelled ACNP on January 1, 1980. The Commission denied this request. Before the district court, HL&P successfully argued that if it had cancelled ACNP on January 1, 1980, it would have incurred cancellation costs properly chargeable to the ratepayers. As a result, the district court remanded this cause to the Commission with instructions that it hear evidence on the ACNP cancellation costs.

District courts may remand a cause to an agency for consideration of additional evidence and issues. Tex. Rev. Civ. Stat. Ann. art. 6252-13a, § 19(d)(2) (Supp. 1986). The exercise of this authority is proper where the evidence is material, and good reason exists for the failure to present the evidence before the agency. *Id;* Texas Oil & Gas Corp. v. Railroad Com'n of Texas, 575 S.W.2d 348 (Tex. Civ. App. 1978, no writ).

The Commission argues that HL&P did not plead for the district court to remand this cause to the Commission under § 19(d)(2). Nonetheless, HL&P's petition clearly asserts that the Commission erred in failing to include cancellation costs incurred in connection with ACNP. HL&P also asserted that cancellation costs would have been incurred even if ACNP had been cancelled on January 1, 1980. We find that HL&P's petition clearly indicated to the district court and to the Commission that

HL&P sought cancellation costs. Moreover, we have searched the record and find no objection by the Commission asserting the absence of pleadings for remand under § 19(d)(2). Insufficiency of pleadings cannot be raised for the first time in the appellate courts. Sherman v. Provident American Insurance Company, 421 S.W.2d 652 (Tex. 1967); Lowther v. Lowther, 578 S.W.2d 560 (Tex. Civ. App. 1979, writ ref'd n.r.e.).

In reviewing a trial court's determination of a matter within its discretion, an appellate court cannot simply substitute its own judgment for that of the trial court. Pratt v. Texas Dept. of Human Resources, 614 S.W.2d 490 (Tex. Civ. App. 1981, writ ref'd n.r.e.). Rather, it must determine if the trial court's decision was arbitrary or unreasonable. Landry v. Travelers Ins. Co., 458 S.W. 2d 649 (Tex. 1970).

We have concluded that the district court did not act arbitrarily or unreasonably in remanding this cause to the Commission on the issue of cancellation costs as of January 1, 1980. The additional evidence is material in that it may establish an allowable expense. Regulatory agencies may not arbitrarily disallow expenditures; if shown to be actual, necessary, and reasonable, cancellation costs may be a recoverable operating expense. Suburban Utility Corp. v. P.U.C. of Texas, *supra*. Although the Commission has the power to disallow improper expenses, nothing in the record indicates that cancellation costs were considered at the rate hearing. The Commission, if it had considered evidence on cancellation costs as of January 1, 1980, could have reached a conclusion contrary to its present position. The substance of the Commission's argument is simply that HL&P is not entitled to the recovery of cancellation costs because it did not cancel ACNP by January 1, 1980.

There is also good reason for HL&P's failure to present evidence on cost of cancellation as of January 1, 1980. HL&P did not know, and could not reasonably anticipate

that the Commission would impose retroactively January 1, 1980 as a prudent cancellation date. In addition, we note that there is no finding that the decision to undertake the ACNP was imprudent. After the cut-off date was announced by the Commission in its final order, HL&P urged the Commission to consider hearing evidence of cancellation costs as of the cut-off date in its motion for rehearing. We overrule the Commission's fifth and sixth points of error.

In its seventh point of error, the Commission attacks the district court's allocation of a portion of ACNP tax benefits to HL&P and its shareholders. HL&P incurred $166 million of expenses in ACNP after January 1, 1980. Because of the imposed prudent cancellation date, these costs were not recoverable from the ratepayers. HL&P proposes to treat the entire $362 million spent on ACNP as a tax loss. In its motion for rehearing, HL&P asserted that the tax benefits associated with the $166 million in disallowed ACNP costs should be allocated to HL&P and its shareholders. The tax benefits associated with the costs incurred before the cut-off date would be passed on to the ratepayers. The Commission ordered HL&P to flow back to the ratepayers the value of any tax benefit attributable to the $166 million in disallowed ACNP costs. The district court reversed this order and allocated this benefit to HL&P.

In response to HL&P's argument that tax benefits must follow the assignment of costs, the Commission offers three contentions. First, under *Suburban Utility*, the Commission has discretion to disallow improper expenses. Thus, the award of these tax benefits to the ratepayers was a proper allocation of cancellation expenses between the parties, and the district court improperly substituted its judgment for that of the Commission. Second, under the district court order, ratepayers will be required to assume a greater income tax expense than necessary. *See* Suburban Utility Corp. v. P.U.C. of

Texas, *supra*. Finally, the Commission appears to argue that if the $166 million is written off by HL&P and its shareholders, this write-off will generate a "phantom" tax expense for the ratepayers.

We find that *Suburban Utility* offers no support for the Commission's initial position. Although *Suburban Utility* grants the Commission discretion to disallow improper expenses in computing rates, that is not what the Commission did in this instance. HL&P is not seeking to include an expense in its rate base; in fact, the $166 million in question was expressly disallowed.

Moreover, *Suburban Utility* does not support the contention that the ratepayers will bear a greater income tax expense than necessary. In *Suburban Utility*, the utility chose to operate as a Subchapter S Corporation and *elected* a tax status which prevented it from being taxed at corporate rates. As a result, the shareholders of the utility had tax liability for all income distributed to them by the utility. The court held that although the utility did not pay federal income taxes, it was entitled to a cost of service allowance for federal income taxes either paid by the shareholders on the utility's taxable income, or for the tax it would pay if it was a normal corporation, *whichever was less*. This result was appropriate because the utility elected its tax status. If the utility had been allowed to choose the greater of the two options, there might indeed be a "phantom" tax as now contended by the Commission. In effect, the utility would enjoy a windfall by charging the ratepayers a federal income tax expense not actually incurred by the utility or the shareholders.

Further, the case of Southern Union Gas Co. v. Railroad Commission, 701 S.W.2d 277 (Tex. App. 1985, writ pending) does not control the disposition of this issue. In that case, the utility incurred certain expenses that were improper for ratemaking purposes. Without presenting authority, the utility argued that these expenses

should also not be characterized as tax deductions. Thus, the utility effectively asked the Commission to calculate the rate of return based upon a tax liability in excess of its true tax liability. By contrast, in the instant cause, HL&P has an improper expense and it only seeks to utilize any tax benefit arising out of it.

It appears that if an expense is included in the cost of service, any tax benefit associated with that expense must be allocated to the ratepayers. *See* Suburban Utility Corp. v. P.U.C. of Texas, *supra.* Similarly, tax deductions cannot be allocated to ratepayers where the expenses from which the deductions arise are not includable in the cost of service. To do otherwise would create a situation where tax savings, realized from costs a utility is required to assume, are used to reduce and subsidize rates.

We must determine if the Commission's order allocating the tax benefits was arbitrary, capricious, characterized by an abuse of discretion or a clearly unwarranted exercise of discretion under APTRA § 19(e)(6). This section is construed narrowly; it is not a catchall provision for reviewing the rationale of agency actions. Texas Health Facilities Com'n v. Charter Medical-Dallas, Inc., 665 S.W.2d 446 (Tex. 1984). Nonetheless, it still operates as a safeguard against the prohibited agency action. *Id.* When considering these four prohibited characteristics, the agency's decision requires reversal only "when the reviewing court is able to conclude from the record as a whole . . . that the agency did consider the relevant factors but its choice was a clear error of judgment." Powers, *Judicial Review of the Findings of Fact Made by Texas Administrative Agencies in Contested Cases*, 26 Tex. Tech L. Rev. 475 (1985). We may not substitute our judgment for the agency's decision, and we must affirm if a rational basis for the decision is presented. Imperial American Resources Fund, Inc. v. Railroad Com'n of Texas, *supra.* In summary, as long

as the agency considered the relevant factors and articulated a rational connection between the facts found and the choices made, the decision is not arbitrary or capricious.

We have concluded that the Commission's order directing HL&P to flow back to the ratepayers the value of any tax benefit associated with the $166 million in disallowed ACNP costs was capricious and clearly an unwarranted exercise of discretion under APTRA § 19(e)(6). The $166 million was not includable in the cost of service. The Commission assigned this cost to HL&P shareholders, who should enjoy any resulting tax benefit. We do not find that this result will produce any "phantom" tax for the ratepayers. The Commission does not direct us to any finding of fact or evidence in the record that in any way supports its contention of a "phantom" tax. As set out above, the Commission incorrectly relied on *Suburban Utility*. If the value of the tax write-off is passed on to the ratepayers, HL&P shareholders will in effect be forced to subsidize rates. We overrule the Commission's seventh point of error.

THE STNP LITIGATION

As a result of numerous delays and construction problems with STNP, HL&P sued the project's architect, engineer and constructor, Brown & Root, Inc. The Commission ordered that the ratepayers receive the benefit of any recoveries by HL&P in this litigation. Further, all litigation expenses and any judgments assessed against HL&P were to be assumed by HL&P, and could not be included in the rate base. The district court reversed the Commission's order concluding that all expenses and recoveries in the STNP litigation should be allocated between shareholders and ratepayers in accordance with the respective percentage of cost paid in the construction of STNP. In its ninth point of error, the Commission argues for the reinstatement of its order allocating STNP litigation expenses and recoveries.

On appeal, the Commission asserts that the ratepayers are in a "helpless" position and bear the risk and burden of STNP. While the shareholders have a direct voice in the utility's affairs, ratepayers have no choice but to continue to purchase electricity from HL&P and are completely unable to prevent or effectively protest the decisions of HL&P's management. Moreover, because the ratepayers have borne the risk and burden of STNP, any benefits that might arise from this endeavor should be allocated to the ratepayers.

We find that the Commission clearly erred in awarding the ratepayers all potential benefits of the STNP litigation, while burdening HL&P shareholders with all costs. There is no finding or combination of findings to support the contention that the ratepayers have borne the "risk and burden" of STNP *in total.* There has yet to be a determination as to whether the ratepayers or the shareholders ultimately will pay for STNP. The Commission's position places the utility in the position of bringing lawsuits for the benefit of ratepayers. We cannot reasonably say that the Commission considered the relevant factors in reaching this decision, or presented a rational basis for it. All expenses and recoveries in the STNP litigation are to be allocated between shareholders and ratepayers in accordance with the respective percentage of cost paid by each in the construction of STNP. We overrule appellant's ninth point of error.

THE DOW ORDER

During the presentation of HL&P's case before the Commission, HL&P proposed three rate schedules for industrial consumers: Large Overhead Service (A)," also known as "LOS-A"; "Large Overhead Service (B)," also known as "LOS-B"; and "Dow contract for Firm and Interruptible Service." Both of the LOS rate schedules were for firm power—not interruptible. Before the Commission and district court, Dow asserted that the Commission was allowing HL&P to charge Dow a rate sig-

nificantly more for firm electric service power than HL&P charged other large industrial consumers under the LOS-B rate schedule. As a result, Dow would pay $2,692,240 more for the same amount of firm power each year. Dow complained of the discriminatory relationship between its rate for firm service and the LOS-B rate given other large industrial customers. The Commission's final order does not reach a conclusion as to the discriminatory relationship between these rates. The district court remanded the Dow portion of the appeal to the Commission for entry of specific findings as to rate discrimination. In its tenth point of error, the Commission argues that specific findings are not required as to Dow and the trial court erred in remanding the Dow appeal to the Commissison.

The Commission relies on the rule that it is given broad discretion to determine the method of rate design, so long as it is "just, reasonable and not unreasonably discriminatory." Texas Alarm & Signal, 603 S.W.2d at 772. Classifications in a rate proceeding may be based upon any number of factors: "the cost of service, the purpose for which the service or product is received, the quantity or amounts received, the different character of the services furnished, the time of its use or any other matter which presents a substantial difference as a ground of distinction." Caldwell v. City of Abilene, 260 S.W.2d 712, 714 (Tex. Civ. App. 1953, writ ref'd n.r.e.), *quoted with approval* in Texas Alarm, 603 S.W.2d at 702. In view of these broad guidelines, the Commission concludes that specific findings were not required as to Dow.

Dow responds that the findings of fact in the Commission's final order are insufficient because they do not satisfy the statutory criteria required by PURA in §§ 38 and 45. Section 38 directs the Commission to insure that its rates are just, reasonable and not unreasonably discriminatory. This standard is applicable to the Commission in its setting of rates. Amtel Communications

v. P.U.C. of Texas, 687 S.W.2d 95 (Tex. App. 1985, no writ). Section 45 forbids unreasonable discrimination by a utility as to rates or services. Thus, it only applies to practices by a public utility. *Id.*

The Commission's final order includes the following finding of fact:

> The record is inconclusive on whether Dow rates are discriminatory relative to LOS-B rates, and therefore an inquiry should be instituted to investigate the issue more fully. In the meantime, the rate design stipulated to in this case for Dow and LOS-B should be approved.

There are no other findings of fact or conclusions of law that appraise the discriminatory characteristics of the Dow firm rate order. From this single finding, it is in no way evident that the Commission assessed and acted upon the criteria set forth in §§ 38 and 45 of PURA.

We acknowledge that § 37 grants the Commission the power of *reasonable* classification; and by implication, some degree of discrimination may be in the public interest under *certain* conditions and circumstances. In such a case, discrimination would not be a violation of PURA. Amtel Communications v. P.U.C. of Texas, *supra.* Nonetheless, §§ 38 and 45 require the Commission to determine "*when* different rates, preferences, or advantages become *unreasonable* as between classes or within a class, and therefore unlawful." *Id.* at 101 (emphasis in original). Under these sections, it must be evident that the Commission assessed the statutory criteria of unreasonable discrimination, and unjust, unreasonable, or unreasonably discriminatory rates to conclude ultimately that no violation of PURA §§ 38 and 45 was indicated. Amtel Communications v. P.U.C. of Texas, *supra.* In other words, in a contested case, the Commission must find that the prohibitions and directives of those sections were not violated. The Commission's single finding fails to satisfy this requirement.

We are again guided by the Supreme Court's holding in *Charter Medical* to consider if from *any* of the agency's individual findings of fact there is:

> . . . any ground or set of grounds which *the court* believes sufficient to "support" in a general way the determinations reached by the agency. . . .

Amtel Communications, 687 S.W.2d at 107 (Emphasis in original). The Commission's findings do not reflect an agency determination that the discrimination suffered by Dow is not unreasonable in light of other factors clearly implicit in the findings made by the Commission. After considering the Commission's findings in their totality, we hold that they in no way reflect that the Commission appraised the criteria in §§ 38 and 45 of PURA and ultimately concluded that there was no violation of the prohibitions and directives in those sections. We overrule the Commission's tenth point of error.

HL&P CROSS POINTS OF ERROR

By its first cross point, HL&P asserts that the trial court erred in affirming the Commission's order setting January 1, 1980 as the cut-off date for a prudent cancellation of ACNP. The finding is supported by the testimony of Robert Smith-Johannsen, on behalf of the Committee For Consumer Rate Relief. In summary, Smith-Johannsen testified that the decision to continue the ACNP from 1976 to 1979 was questionable in view of escalating capital costs and regulatory burdens. Based upon this testimony, the Commission determined that HL&P was imprudent in failing to cancel ACNP by January 1, 1980.

HL&P attacks Smith-Johannsen's testimony as being clearly defective. This contention rests on HL&P's assertions that Smith-Johannsen lacked expertise on the subject matter about which he testified and further, he relied on unreliable hearsay sources. On this basis, the

Commission's order would not be supported by substantial evidence as required by APTRA § 19(e)(5). The argument is without merit. It is an established premise that an agency may, or may not accept the testimony of witnesses, experts or nonexperts. Southern Union Gas v. Railroad Com'n of Texas, 692 S.W.2d 137 (Tex. App. 1985, writ ref'd n.r.e.). The agency must judge the weight to be accorded the testimony of each witness. *Id.*

HL&P also argues that its management decisions were not evaluated under the circumstances in which they were made. The record does not support this position. The examiner's report concludes that HL&P ignored historical data available from 1976 to 1979. Pertinent information included a comparative examination of plant capacity factors for nuclear and coal operations and a substantial increase in safety promulgations from the Nuclear Regulatory Commission in light of the Three Mile Island accident. Moreover, Smith-Johannsen stated that the prudence of HL&P in its cancellation of ACNP should be determined by an inquiry into the reasonableness and rationality of management judgment under circumstances *existing at this time* (1976-1979). We find nothing in the record to suggest that the Commission used a "hindsight approach" in assessing the judgment of HL&P's management. The first cross point of error is overruled.

The second cross point contests the trial court's affirmance of the Commission's order refusing to allow any return or interest on the unamortized balance of the pre-January 1, 1980 ACNP construction costs. As noted above, the Commission has discretion to allow or disallow certain expenses for rate making purposes. Tex. Rev. Stat. Ann. art. 1446c, § 41(c)(2) (1980 and as amended to 1982); Suburban Utility Corp. v. P.U.C. of Texas, *supra*. The record further reflects that straight line amortization has been applied by the Commission in similar situations. We overrule HL&P's second cross point of error.

HL&P also asserts that it was denied procedural and substantive due process because it relied on an earlier rate proceeding that considered HL&P's management of STNP. This earlier proceeding established a separate docket and specific procedure by which the Commission was to monitor STNP. HL&P contends that it received no notice that STNP management was to be an issue in docket 4540, the cause at bar. The Commission's consideration of STNP mismanagement was only evident in its imposition of the rate penalty and in its allocation of STNP litigation costs. Because we have already held for HL&P on these issues, HL&P's third cross point is moot.

The final cross point of HL&P argues that the Commission's reduction of the rate of return of Utility Fuels, Inc., HL&P's coal-supply affiliate is: (1) not supported by substantial evidence, (2) arbitrary and capricious, and (3) an abuse of discretion. The examiner's report recommends that Utility Fuels' rate of return of 17% be lowered by using Utility Fuels' capital structure as of the date the rate increase hearing was filed by HL&P. After reviewing the testimony noted in the examiner's report, we conclude that there is substantial evidence to support the Commission's lowering of Utility Fuels' rate of return. HL&P's fourth cross point of error is overruled.

We modify the judgment of the district court, and as modified, it is affirmed.

JIMMY CARROLL, Justice

[Before Chief Justice Shannon, Justices Gammage and Carroll]

Modified and as Modified, Affirmed

Filed: July 2, 1986

APPENDIX D

Final Judgment of the District Court of Travis County

IN THE DISTRICT COURT
OF TRAVIS COUNTY, TEXAS
201ST JUDICIAL DISTRICT

No. 343,112
(Consolidated)

HOUSTON LIGHTING & POWER COMPANY, *et al.*,
Plaintiff,

vs.

PUBLIC UTILITY COMMISSION OF TEXAS,
Defendant.

FINAL JUDGMENT

The portion of the above-entitled cause involving the claims of Plaintiffs Houston Lighting & Power Company ("HL&P") and the Cities of Houston and Lake Jackson came on for trial on the merits, pursuant to proper setting, of which all parties had due notice, on the 8th day of July, 1983. The Plaintiff, HL&P, appeared by its attorneys; the Defendant, Public Utility Commission of Texas (the "Commission"), appeared through the Attorney General of Texas; and Plaintiff-Intervenors City of Houston and City of Lake Jackson appeared through their attorneys; all parties announced ready for trial.

Whereupon the Court proceeded to try the case pursuant to the Administrative Procedure and Texas Register Act (the "APA"), Tex. Rev. Civ. Stat. Ann. art. 6252-13a. The administrative record before the Commission in its Docket No. 4540 was introduced and received into evidence. Oral argument was heard on July 8, 1983, and June 8, 1984. Following review of the administrative

record in evidence, and consideration of the briefs filed by the parties, and of the arguments of counsel, it is the opinion and judgment of the Court that:

A. With respect to the claims of Plaintiff HL&P, the final order of the Commission in its Docket No. 4540 dated December 6, 1982, is unlawful and erroneous in the following respects:

1. The Commission erred by reducing HL&P's rate of return on equity from 16.85% to 16.35% as a penalty for mismanagement. There is no statutory authority for penalizing a utility by reducing its rate of return for "mismanagement"; accordingly, paragraph "B" of page 1 of the Commission's Final Order is reversed.

2. The Commission erred in not permitting HL&P to recover the cancellation costs that reasonably would have been incurred had the Allens Creek Nuclear Project ("Allens Creek") been cancelled on January 1, 1980. Since the amount of these costs cannot be fully determined from the present record, further proceedings before the Commission should be instituted on this limited issue.

3. The Commission erred in holding that the income tax benefits flowing from the write-off of that portion of the Allens Creek expenditures that may not be recovered by HL&P from its ratepayers should be treated as a credit to the tax expense over the 10-year amortization period. The tax benefits should follow the assignment of the expenditures giving rise to such benefits. Since the Commission found that HL&P's stockholders, and not its ratepayers, should bear the disallowed Allens Creek expenditures (approximately $166,000,000.00), the shareholders should receive any and all tax benefits associated with these expenditures. Accordingly, paragraph VI of the Commission's Final Order is reversed insofar as it requires the erroneous tax treatment discussed above.

4. The Commission erred by ordering that "all recoveries associated with the Allens Creek Nuclear Project,

including costs avoided through negotiation of existing contracts, or other arrangements" in connection with cancellation of Allens Creek, should be passed through to ratepayers in HL&P's annual rate filings. Since the costs of Allens Creek are being allocated to either shareholders or ratepayers, reductions in such costs or recoveries should be treated in a similar fashion. If a particular Allens Creek expense item has been included in either the total costs recoverable from ratepayers or in the total costs attributable to the shareholders, and through negotiation or otherwise such particular expense item is reduced or value is received for such item, then the amount of such cost reduction or value received should be credited against either the total Allens Creek costs recoverable from ratepayers or the total Allens Creek cost attributable to stockholders, depending upon the initial classification of the particular expense item in question. Accordingly, paragraph 6 on page 5 of the Commission's Order is reversed to the extent inconsistent with the foregoing paragraph.

5. The Commission erred in its mathematical computation of the amounts of pre-January 1, 1980, expenditures for Allens Creek by subtracting the post-January 1, 1980 expenditures from a total figure that did not include all expenditures. This method of computation and use of an erroneous total cost figure had the effect of transferring approximately $17,000,000.00 of pre-January 1, 1980 expenditures to the post-January 1, 1980, category. This error should be corrected on remand.

6. The Commission erred in providing that none of the expenses of the South Texas Project litigation with Brown & Root, Inc. and Halliburton Company shall be recovered from the ratepayers and that all recoveries in such litigation must be passed through to the ratepayers. Both expenses and recoveries should be allocated between shareholders or ratepayers, dependent upon which paid for the items giving rise to the recovery. If ratepayers

ultimately pay 100% of the plant's cost, then they should receive 100% of any recovery and pay 100% of the litigation expenses. To the extent the ratepayers ultimately pay less than 100% of the plant's costs, their interest in any recovery and obligation for litigation expenses would be reduced correspondingly, such reduction to depend upon whether or not the recovered costs in question and related litigation expenses are being borne by the ratepayers. Costs recovered with respect to costs being borne by the shareholder should likewise be credited to the shareholder, together with any related litigation expenses. Accordingly, paragraphs 3 and 4 on page 5 of the Commission's Final Order are reversed.

7. Because the controversy between the owners of the South Texas Project, including HL&P, and Brown & Root, Inc. and Halliburton Company is pending before the judicial branch, the Commission's conclusions regarding HL&P's management of the South Texas Project are premature and presumptuous and cannot be made the basis of any actions taken by the Commission in Docket No. 4540, or to be taken upon the remand hereinafter ordered.

This proceeding should be remanded to the Commission for further proceedings. On remand, the Commission shall:

(a) initiate proceedings to ascertain the reasonable cancellation costs that would have occurred had Allens Creek been cancelled on January 1, 1980, and then correctly compute the total Allens Creek costs incurred prior to January 1, 1980, plus reasonable cancellation costs, and the total costs incurred after January 1, 1980 (other than reasonable cancellation costs) on Allens Creek;

(b) determine the rates HL&P should have been permitted to charge as a result of Docket No. 4540 had the errors discussed in paragraphs 1, 2, 3, 4, and 5 above not been made and place those rates into effect;

(c) determine the revenues that would have been generated by application of the new rates determined in pargaraph (b) above to actual sales volumes, or such volumes as the Commission determines would have been consumed under the paragraph (b) rates, in the period between October 20, 1982, and the date such new rates, or successor rates, become effective and then subtract the revenues actually received and not refunded in such period pursuant to the rates implemented pursuant to the Commission's Final Order in Docket No. 4540;

(d) determine the amount of interest paid by HL&P in refunding its bonded rates in Docket No. 4540 that would not have been paid had the rates determined in (b) above been applied instead of the rates filed in response to the Final Order in Docket No. 4540;

(e) through the use of a mechanism such as a surcharge, temporary rate increase, or similar procedure approved by the Commission, authorize HL&P to collect the amounts determined pursuant to paragraphs (c) and (d) above, plus interest on such sums from the time such rates should have been charged through the time such rates are billed.

The intent of pargraphs (a) through (e) above is to place HL&P and its customers in the same financial position each would occupy had the errors discussed above not been made.

Except as expressly stated herein, the order of the Commission in Docket No. 4540 as to HL&P is affirmed and all relief sought herein by HL&P not expressly granted herein is denied.

B. With respect to the claims of Plaintiffs City of Houston and City of Lake Jackson, all such claims are denied and it is Ordered, Adjudged and Decreed that the Cities of Houston and Lake Jackson as Plaintiffs take nothing by their action.

C. This Final Judgment incorporates by reference the Interlocutory Judgment in Cause No. 343,112 (Consolidated) signed and entered August 16, 1983, which inter-

locutory judgment shall become final through the rendition and entry of judgment herein.

All issues in this consolidated cause now having been disposed of, this Judgment shall be considered the final judgment in this consolidated cause.

Filed and entered this 13th day of September, 1984.

/s/ Herman Jones
HERMAN JONES
District Judge Presiding

APPROVED AS TO FORM:

ROBERT J. HEARON, JR.
GRAVES, DOUGHERTY, HEARON & MOODY
2300 InterFirst Tower
P. O. Box 98
Austin, Texas 78767

Hugh Rice Kelly
BAKER & BOTTS
3000 One Shell Plaza
Houston, Texas 77002

By: /s/ Hugh Rice Kelly
HUGH RICE KELLY
State Bar No. 11220500

Attorneys for Plaintiff
Houston Lighting & Power Company

FERNANDO RODRIGUEZ
Assistant Attorney General
P. O. Box 12548
Austin, Texas 78711

/s/ Fernando Rodriguez
FERNANDO RODRIGUEZ

Attorney for Defendant
Public Utility Commission
of Texas

REX D. VANMIDDLESWORTH
MAYOR, DAY & CALDWELL
900 North Tower
Pennzoil Place
Houston, Texas 77002

By: Rex D. VanMiddlesworth
REX D. VANMIDDLESWORTH
Attorneys for Texas
Industrial Energy Consumers

JOHN DEWEY
City Attorney
24 Oak Drive
Lake Jackson, Texas 77566

JOHN DEWEY
Attorney for City of
Lake Jackson, Texas

ADRIAN S. BAER
Assistant City Attorney
P. O. Box 1562
Houston, Texas

ADRIAN S. BAER
Attorney for City of
Houston, Texas

JEFFERSON D. GILLER
FULBRIGHT & JAWORSKI
800 Bank of the Southwest
Houston, Texas 77002

/s/ Jefferson D. Giller
JEFFERSON D. GILLER
Attorney for the Dow
Chemical Company

APPENDIX E

Final Order of the Public Utility Commission of Texas, Together with Examiner's Report, Docket No. 4540

PUBLIC UTILITY COMMISSION OF TEXAS

Docket No. 4540

APPLICATION OF HOUSTON LIGHTING AND POWER COMPANY FOR A RATE INCREASE

FINAL ORDER

In public meeting at its offices in Austin, Texas, the Public Utility Commission of Texas finds that after statutory notice was provided to the public and to interested parties, a hearing in the above styled cause was conducted by an examiner who issued a Report containing Findings of Fact and Conclusions of Law, which Report is adopted in part and modified in part, as follows:

The application of Houston Lighting and Power Company (HL&P) is hereby GRANTED in part and DENIED in part, as set out in the Examiner's Report, as amended on November 16, 1982, subject to the following modifications:

I. *Revenue Related Modifications*

A. The invested capital of HL&P shall be reduced by $2.8 million. HL&P had accrued this amount for a Liquid Metal Breeder Reactor Project which has since been terminated. This is cost free capital and should be deducted from invested capital.

B. The cost of equity shall be reduced by .5% to 16.35%. This is a penalty for poor management, and shall remain in effect until HL&P's next rate case, and is not subject to recovery at some future time.

C. The following Findings of Fact & Conclusions of Law shall be changed, as a result of the above modifications, as follows:

Page 68,—Finding of Fact No. 6,—should be changed to read:

6. HL&P's capital is valued at $3,951,544,000, as shown below:

(In Thousands of Dollars)

Plant in Service	$3,962,797
Accumulated Depreciation	797,665
Net Plant	$3,165,132
Construction Work In Progress	947,699
Property Held For Future Use	3,180
Nuclear Fuel	60,769
Working Cash Allowance	44,531
Materials and Supplies	42,257
Prepayments	3,267
Fuel Inventory	76,706
Less	
Deferred Taxes	330,228
Pre 1971 Investment Tax Credits	8,279
Customer Deposits	20,695
Property Insurance Reserve	8,120
Other Cost Free Capital	24,675
Total Invested Capital	$3,951,544

Page 68,—*Finding of Fact No. 7*, should read:

7. The rate base adjustments recommended by the examiner, including the additional adjustment of an increase to cost free capital of $2.8 million, which reduces invested capital by this same amount, and used in deriving Finding of Fact No. 6, are reasonable for the reasons stated in this Report.

Page 68—*Finding of Fact No. 9*,—should read:

9. A balance of 34.625 percent net current cost and 65.375 percent net original cost is reasonable for the purpose of calculating the adjusted value of HL&P's invested capital. Using these percentages, the adjusted value of HL&P's invested capital is $4,938,-387,000. See also, attached revised Exhibits I and II.

Page 69, *Finding of Fact No. 11*, should read:

11. For reasons set out in this Report, 16.85 percent return on common equity capital is reasonable for HL&P. An annual return of $499,435,000, which constitutes a 12.63 percent return on HL&P's invested capital, and a 10.11 percent return on the adjusted value of HL&P's invested capital, is fair and reasonable, is adequate under efficient management to allow HL&P to maintain its current credit rating and to attract the capital necessary for the proper discharge of its duties as a public utility, and is sufficient to insure confidence in the financial integrity of the company.

However, the return on equity set forth above is reasonable *only* under circumstances of efficient management. Because the evidence in this case establishes that HL&P has been imprudent in its management on many occasions in the past, such as its handling of STP, its purchase of coal without first test-burning it, its unusual handling of ACNP in this docket, its use of an 80% capacity factor in its studies on ACNP when NRC data showed a 56% capacity factor to be prudent, as well as other instances which are supported by the examiner and the record in this proceeding, HL&P should be penalized by lowering its return on common equity by .5% to 16.35%. Thus, a return of $489,991,000 in this docket is proper and reasonable. This penalty shall remain in effect until the company's next rate case, and is not subject to being recovered at some future time.

Page 70, *Finding of Fact No. 24*, should read:

24. HL&P's adjusted test period revenue deficiency is found to be $182.6 million, rather than the $336 million as stated by the company in its rate-filing schedules.

Page 71—*Conclusion of Law No. 3*, should read:

3. HL&P proved that it is entitled to additional annual revenues of $182.6 million.

II. *Modifications—South Texas Nuclear Project*

A. The $1.7 billion ceiling placed on HL&P's share of the South Texas Nuclear Project shall be deleted, so as to avoid any implication that the Commission might be approving expenditures for STP to this level, or the implication that HL&P need not eventually prove that all dollars expended on STP over the years must be proved reasonable to the satisfaction of the satisfaction of the Commission.

B. The following Findings of Fact and Conclusions of Law shall be changed, as a result of the modifications set forth directly above, as follows:

Page 69, *Finding of Fact No. 16* should read:

> The record evidence establishes that HL&P has mismanaged STP. It is clear that HL&P is responsible for the delays at STP and for not responding to problems at STP in a more timely fashion. HL&P has shown mismanagement, not only in its handling of STP, but in its purchase of coal without first test-burning it, its unusual handling of ACNP, and its use of an 80% capacity factor in its studies on ACNP when NRC data showed a 56% factor to be prudent, and various other instances which are supported by the Examiner's Report and the record herein.

Page 69, *Finding of Fact No. 17* should read:

17. Protective measures having to do with the Court suit between HL&P and B&R should be adopted.

III. *Modifications—Rate Design*

A. The ratchet provision for Texas New Mexico Power Company shall be lowered to 75%.

B. The General Counsel's office shall institute an inquiry into the relationship between the firm rate for Dow relative to the firm rate for LOS-B customers. This inquiry shall be limited to the rates charged only to these customer classes, and shall be consolidated with the docket which will result from HL&P's filing of a tariff for interruptible power in conformance with the examiner's recommendations.

C. Findings of Fact should be changed, as a result of the modifications set forth directly above, as follows:

Page 70—*Finding of Fact No. 27* should read:

27. The record supports a change in TNP's ratchet to 75%; however, the record does not support TNP's theory that certain costs should not be allocated to TNP.

Page 70—*Finding of Fact No. 29*, should read:

29. The record is inconclusive on whether Dow rates are discriminatory relative to LOS-B rates, and therefore an inquiry should be instituted to investigate the issue more fully. In the meantime, the rate design stipulated to in this case for Dow and LOS-B should be approved.

IV. *Additional Language and Findings of Fact—Rate Design*

A. The Examiner's Report shall be amended at page 55, to include the entire stipulation on rate design, as follows:

Page 55—after Number 2, add:

"As to revenue assignment, the stipulation provided that:

3. The methodology for assignment of revenue from the customer classes provided by staff witness Kent Saathoff is also appropriate. Each rate class should be assigned revenue to move it one-half the way toward a relative rate of return of unity where possible. However, no class should receive more than approximately one and one-half or less than one-half times the system wide percentage increase in total revenue. The only exception should be the Public Utility class which should be assigned its cost based revenue."

B. Finding of Fact No. 26 shall be changed to read:

26. Staff's allocation methodology and methodology for assignment of revenue from the customer classes is appropriate in this docket for the reasons stated in this Report."

C. Finding of Fact No. 34 shall be added, as follows:

34. HL&P's rate design for the residential class is reasonable.

V. *Affiliated Fuel Costs—Modification*

The examiner's recommendations shall be modified so that HL&P shall file a tariff and associated costs by December 20, 1982 for costs to be set for the period April 1, 1983, through June 30, 1983. The formula for UFI fuel costs set forth in the Examiner's Report, and as modified by the examiner, shall remain in effect only until April 1, 1983.

VI. *Treatment of Taxes Associated with Allen's Creek Nuclear Project*

For purposes of clarification, the Commission hereby adopts the examiner's treatment of the tax benefits associated with the $166 million of expenditures disallowed for the Allen's Creek Nuclear Project (ACNP). This $166 million unrecoverable portion of ACNP expenditures will be written off for tax purposes and will result in tax savings to HL&P. These savings should properly inure to the benefit of the ratepayer as a credit to tax expense. The tax benefit should be spread over the ten-year amortization period adopted herein for ratemaking purposes. The examiner's tax calculation, which calls for HL&P to bear the burden of the $166 million disallowance, after taxes, is explicitly approved herein.

IT IS FURTHER ORDERED that:

1. HL&P shall report to this Commission within twelve months before the filing of a rate case in which it intends to include South Texas Nuclear Project in rate base.

2. HL&P shall report to the Commission within six months before implementation of any substantial changes associated with the STP project.

3. HL&P shall pass through to ratepayers any amounts the courts may award HL&P in its lawsuit against Brown and Root in HL&P's next rate case following such award.

4. Any amounts assessed against HL&P in its court suit, including expenses for the suit it has filed against Brown & Root, shall not be recovered in any manner from HL&P ratepayers.

5. HL&P is hereby advised that if, in the future, it incurs abnormal customer outages, this Commission will give serious consideration to ordering neighbor-

ing utilities to serve existing or new customers within HL&P's certificated service area.

6. HL&P shall pass through to ratepayers, in its annual rate filings, all recoveries associated with the Allen's Creek Nuclear Project, including all amounts for equipment sold, and costs avoided through negotiation of existing contracts, or other arrangements. These recoveries are to be used to reduce the unamortized balance of approximately $195 million. Thus, it is to be made clear that recoveries from salvage shall inure to the benefit of customers and the balance yet to be amortized of $195 million shall be reduced by any such recoveries. However, any recoveries associated with equipment acquired, contracts made, or any other arrangements, which can be clearly shown to be related to the period January 1, 1980 to August 26, 1982, shall not be used to reduce the unamortized balance of $195 million. The method of allocation by which the amounts associated with ACNP and STP shall be refunded to each customer class shall be litigated in HL&P's next rate case.

7. Beginning with February 1983, billings, HL&P shall not list individual cost of service items, such as fuel, separately on customer bills.

8. HL&P shall file a tariff, and details of costs associated with its affiliated fuel costs, by December 20, 1982, for the purpose of setting fuel costs for affiliated interests for the period April 1, 1983 through June 30, 1983. The procedure shall repeat itself on a quarterly basis. The next tariff filing should then be filed on or before April 1, 1983 for the quarter beginning July 1, 1983. No affiliated costs shall be passed through automatically to HL&P ratepayers after April 1, 1983.

9. HL&P shall file a proposed interruptible tariff, as recommended in the Examiner's Report, within

ninety (90) days of this Order. General Counsel shall file an inquiry into the relationship between the firm rate for Dow relative to the firm rate for LOS-B customers. This inquiry shall be limited to the rates changed only to these customer classes, and shall be consolidated with the docket which will result from the filing of a proposed interruptible tariff by HL&P.

10. HL&P shall file a revised tariff in accordance with the Opinion, Findings of Fact, and Conclusions of Law herein sufficient to generate revenues not greater than those prescribed in this Order. HL&P shall file a copy of its revised tariff on all parties of record at the same time that it is filed with the Commission. The parties shall have ten (10) days from the date of such filing to present their written objections to the revised tariff, if any, to the Commission staff for its review and consideration. The Commission staff shall have twenty (20) days from the date of such filing of the revised tariff to review it for approval or rejection. The tariff shall be deemed to be approved and shall become effective upon the expiration of twenty (20) days after filing, or sooner upon notification by the Commission Secretary. In the event of rejection, HL&P shall be notified and a copy sent to the intervening parties herein by the examiner, and HL&P shall have fifteen (15) additional days to file an amended tariff and the same procedure shall be repeated herein. The revised and approved rates shall be charged by HL&P for electricity consumed after the tariff approval date. This Order is deemed to be final on the date of rendition. Approval of the tariff, for all purposes, shall be deemed to be final on the date of its effectiveness either by operation of this Order or by notification by the examiner, whichever occurs first. If the date of approval of tariff falls within HL&P's normal customer billing cycle, HL&P is au-

thorized to prorate customer bills to charge customers for consumption each day of the month under the appropriate tariff in effect on that day of the month.

11. All motions, requests, applications, and requests for Findings of Fact and Conclusions of Law not expressly granted herein are denied for want of merit.

SIGNED AT AUSTIN, TEXAS, on this 6th day of December, 1982.

PUBLIC UTILITY COMMISSION
OF TEXAS

Signed: H. Moak Rollins
H. MOAK ROLLINS

Signed: George M. Cowden
GEORGE M. COWDEN

Signed: T. G. Smith
T. G. SMITH

ATTEST:

/s/ Jacqueline ——— for
RHONDA COLBERT RYAN
Acting Secretary of the Commission

tqb

EXHIBIT 1

HOUSTON LIGHTING & POWER COMPANY—4540
REVENUE REQUIREMENT
(000's)

Description	Test Year Per Books	Company Adjustments	Company Test Year	Staff Adjustments	Staff * Test Year	City Adjustments	City Test Year	Examiner Adjustments	Examiner Test Year
Fuel	$1,673,251	$129,325	$ 1,802,576	$110,803	$ 1,913,379	$ 30,732	$ 1,833,308	$110,803	$ 1,913,379
Purchased Power	130,764	95,139	225,903	9,667	235,570	0	225,903	9,667	235,570
Operations and Maintenance	330,850	55,871	386,721	(84,540)	378,868	(7,260)	379,461	(83,590)	379,818
Extraordinary Amortization	3,044	91,112	94,156	(38,329)	55,827	(91,112)	3,044	(71,600)	22,556
Depreciation	117,376	16,257	133,633	0	133,634	(4,933)	128,700	0	133,634
Other Taxes	95,012	22,495	117,507	74,663	192,170	(2,409)	115,098	72,593	190,100
Franchise Fees	60,166	16,521	76,687	—	—	(2,621)	74,066	—	—
Interest on Customers Deposits	0	1,225	1,225	0	1,225	0	1,225	0	1,225
Federal Income Taxes	178,222	118,223	296,445	(19,132)	277,313	(30,673)	265,772	(43,263)	253,182
Return	354,694	165,305	519,999	(19,552)	500,447	(16,655)	503,344	(30,008)	489,991
Revenue Requirement	$2,943,379	$711,473	$ 3,654,852	$ 33,581	$ 3,688,434	$(124,931)	$ 3,529,921	$(35,397)	$ 3,619,456
Less									
Other Revenue	$ 74,218	$ 17,560	$ 91,778	$ (1,355)	$ 90,423	$ (2,621)	$ 89,157	$ (2,850)	$ 88,928
Fuel Revenues	1,779,830	204,175	1,984,005	120,470	2,104,475	30,732	2,014,737	$120,470	$ 2,104,475
Base Rate Revenue	$1,089,331	$489,738	$ 1,579,069	$(85,534)	$ 1,493,536	$(153,042)	$ 1,426,027	$153,017)	$ 1,426,053
Less Test Period Base Rate Revenue Adjusted			$(1,243,371)		$(1,243,371)	$ (1,095)	$(1,244,466)		$(1,243,371)
Base Rate Revenue Deficiency			$ 335,698		$ 250,165	$(154,137)	$ 181,561		$ 182,682

* Based on Staff Ex. No. 17, revised downward after hearing

EXHIBIT II

PUBLIC UTILITY COMMISSION OF TEXAS

HOUSTON LIGHTING AND POWER—DOCKET 4540

ADJUSTED VALUE OF INVESTED CAPITAL

	Mix Computation	Adjusted Amount
Net Plant at Original Cost	$3,165,132	
Percentage Mix	.6538	
Original Cost Plant		$2,069,205
Net Plant at Current Cost	$6,015,220	
Percentage Mix	.3463	
Clarent Cost Plant		$2,082,770
Construction Work in Progress		947,699
Property Held for Future Use		3,180
Nuclear Fuel		60,769
Working Cash Allowance		44,531
Materials and Supplies		42,257
Prepayments		3,267
Fuel Inventory		76,706
Less		
Deferred Taxes		330,226
Pre 1971 Investment Tax Credits		8,279
Customers Deposits		20,695
Property Insurance Reserve		8,120
Other Cost Free Capital		24,675
Adjusted Value of Invested Capital		4,938,387
Rate of Return		.0992
Return		$489,991

PUBLIC UTILITY COMMISSION
OF TEXAS

Docket No. 4540

APPLICATION OF HOUSTON LIGHTING AND POWER COMPANY FOR A RATE INCREASE

Examiner's Report

I. Procedural History

On June 16, 1982, Houston Lighting and Power Company (HL&P), filed an application to change rates in the unincorporated areas it serves, effective July 22, 1982. The proposed changes are expected to result in a system-wide annual base revenue increase of $336 million, or approximaetly 10.0 percent of the adjusted total operating revenues for the test year ending March 31, 1982. All classes of customers are affected by the proposed rate change.

A prehearing conference was held on Friday, July 2, 1982, at which time the tariff changes were suspended for the 120 day statutory suspension period, and intervenor status was granted to the following parties:

Texas Industrial Energy Consumers (TIEC)
Texas-New Mexico Power Company (TNP)
Greater Houston Hospital Council (GHHC)
Dow Chemical Company (DOW)
St. Regis Paper Company (St. Regis)
City of Houston (Cities)
Dickinson Independent School District (District)
Committee for Consumer Rate Relief (CCRR)
City of Baytown (Cities)

Diamond Shamrock (DS)
United States Steel Corporation (USS)
Houston Retail Merchant's Association (HRMA)
City of Pasadena (Cities)
City of Lake Jackson (Cities)
Coalition of Cities (Cities)
City of Freeport (Cities)
Department of Energy (DOE)
Mockingbird Alliance
Dr. John Doherty

A procedural schedule was agreed upon and a hearing date set for August 30, 1982. A prehearing conference was held on August 26, 1982. As a result of this conference, several issues in this case were resolved through stipulations. These stipulations will be explained in this Report where appropriate. The hearing was rescheduled to begin September 2, 1982, to give parties time to revise their testimony after HL&P formally announced cancellation of its Allen's Creek Plant Unit No. 1, at the August 26, 1982, prehearing conference. The hearing continued until September 16, 1982; initial briefs were filed October 1; and reply briefs were filed October 8, 1982.

On August 30, 1982, a hearing was held for the purpose of hearing protestant's comments in this case. Numerous protestants appeared. The major complaint concerned bills for electricity which the customers felt were beyond their ability to pay; alleged mismanagement of the company was frequently mentioned. Customers were also upset about HL&P's request, which includes amortization costs for the Allen's Creek Nuclear Plant, when the plant is of "no use to them," as well the construction work in progress (CWIP) associated with South Texas Nuclear Project (STP), which customers allege has been "grossly mismanaged."

This case is unusual in that appeals from all cities served by HL&P, (with the exception of approximately

eight cities which did not act before the end of the hearing before this Commission), have been consolidated with Docket No. 4540. These cities formed a coalition, and presented a rate recommendation as a united group, and were represented by several attorneys throughout the hearings and briefing period.

On October 20, 1982, HL&P placed rates into effect under bond in the unincorporated areas it serves and in those cities which had not acted on the rate increase. Interim rates were placed in effect in those cities whose appeals were consolidated in this docket. This system-wide temporary rate increase utilized a tariff which was designed to meet an overall base rate revenue deficiency of $181 million of the $336 million requested.

II. Background

Houston Lighting and Power Company is a public utility that generates, transmits, distributes, and sells electric energy to customers in the Texas Gulf Coast region. Along with Primary Fuels, Inc. (PFI) and Utility Fuels, Inc. (UFI), HL&P is a subsidiary of Houston Industries Incorporated (HII). PFI is involved in oil and gas exploration and development, but provides no services to HL&P at this time. UFI, however, currently provides coal supply services to HL&P.

HL&P's stated need for additional revenue is to cover its cost of service and to finance its construction programs. Government environmental protection regulations, the need to diversify its fuel mix, and rapid population growth have made it necessary for HL&P to expand its system but the cost of this expansion has increased as prices have escalated. HL&P contends that it must have additional revenues if it is going to be able to attract the capital necessary from outside investors to construct its needed facilities.

As might be expected, the Commission staff and the other parties to the case provided a wide range of opin-

ions on all issues raised by HL&P. Though their recommendations as to the amount of revenue needed by HL&P differed, most agreed that some additional revenues were necessary.

In the discussion that follows, the examiner will attempt to address the major issues that were raised in the case. The positions taken by each of the parties on these issues will be reviewed in as much detail as possible, but because of the number of issues and parties involved, discussion will be limited, where appropriate, to those areas stressed by each party.

III. Invested Capital

In its rate filing package, HL&P stated the total value of its invested capital to be $4,006,153 (in thousands of dollars) based on the following components:

Description	Amount (in thousands of dollars)
Electric Plant in Service	$3,962,797
Less Accumulated Depreciation	789,536
Net Plant	3,173,261
Construction Work in Progress	959,955
Electric Plant Held for Future Use	20,957
Nuclear Fuel in Process	60,409
Working Capital	171,146
Deferred Federal Income Taxes	(324,235)
Pre-1971 Unamortized Investment Tax Credits	(8,279)
Customer Deposits	(20,695)
Customer Advances for Construction	(18,246)
Reserve for Property Insurance	(8,120)
Total Invested Capital	$4,006,153

The other parties to the case proposed a variety of adjustments to these figures, the most significant of which will be discussed below.

A. Depreciation

1. Accumulated Depreciation

The issue of an adjustment to accumulated depreciation to correspond to a change in test depreciation ex-

pense is one which has been frequently addressed by this Commission.

HL&P and staff proposed no adjustment to accumulated depreciation. The Cities and TNP proposed that one-half of the depreciation expense allowed through cost of service, incremental to the test year amount, be included in the reserve for accumulated depreciation to determine the appropriate level of invested capital.

The Cities argue that since the composite depreciation rate is fixed and known, and the plant costs are fixed and known, the actual depreciation that should be used over the period when the new rates will be in effect can be accurately determined. This amounts to a known and measurable change that should be entered as an adjustment to the depreciation expense.

TNP's position is that HL&P's treatment does not fulfill the matching principle of accounting; adjustments for income which fall outside the test year need to be offset with like adjustments for attributable expenses. TNP also argues consistency—the adjustment it proposes here was adopted in TNP's last rate case, Docket No. 4240, where the examiner stated:

> The most recent cases discussing the matter at length appear to suggest that the one-half adjustment is proper for utilities filing rate cases annually, while a full adjustment should be made in instances where the company's rates are expected to remain in effect for more than twelve (12) months. (PUC Bulletin, Vol. VII, No. 11, p. 960).

See also, Docket No. 3460, *Application of Dallas Power and Light Company*, 6 P.U.C. Bull. 720, 724, (February 26, 1981); Docket No. 3510, *Application of Central Telephone Company of Texas*, 7 P.U.C. Bull. 185, 190 (April 20, 1981).

Staff argued that although it had advocated the treatment sought here by the Cities and TNP in the past,

staff has now concluded it is not justified from an accounting standpoint. Staff argued that to choose only one line item of invested capital for adjustment does not prevent an over or underrecovery of return dollars, (as it is claimed this adjustment will do), and the overall application is inconsistent. To be consistent one would have to pro forma expected investment during the period rates are in effect, as well as allowing for any other prospective changes in the balance sheet that are reflected in the determination of the appropriate invested capital.

The examiner agrees with the Cities and TNP that their proposed adjustment should be made and endorses the language previously cited from Docket No. 4240. Since it is reasonable to expect that the rates approved herein will be in effect for only twelve months, the one-half adjustment is proper.

The examiner believes that HL&P's and staff's approach, which increases depreciation expense with no parallel adjustment to depreciation reserve, would in fact result in an overrecovery to the extent that HL&P would be earning return for a full year on that portion of its investment which will be fully recovered by it in the course of that year through the inclusion of depreciation expense in its cost of service.

2. Depreciation Rates for Gas Fired Plants

HL&P's proposed depreciation expense was based on adjusted depreciable plant using the functional depreciation rates approved by the Commission in Dockets No. 2002 and 3320. The staff agreed with both the adjusted depreciable plant balances and the functional depreciation rates and accepted HL&P's adjustment. The City of Houston did not contest the adjusted depreciable plant balances but recommended that the depreciation rates for gas production accounts be changed to the depreciation rates in effect prior to the Commission Order in Docket No. 2001. The city's recommendation was based on the

fact that HL&P had provided information indicating that the rates were changed in 1979 (Docket No. 2001), due to the gas use restrictions under the Power Plant and Industrial Fuel Use Act passed in 1978, and that such restrictions were rescinded in 1981. City witness Winkelmann stated that he believed that fuel oil would be available subsequent to 1996, and therefore his recommendation would remain the same, although the basis for his recommendation was different. HL&P argued rates were in fact changed because of the expiration of a major fuel contract in 1996 and the uncertainty as to the availability of gas subsequent to 1996. Additionally, HL&P argued that the depreciation rates for those units which can burn only gas were based on a 1996 retirement date, but that the units which had the capability of burning oil or gas have a different depreciation rate based on extended service lives. Thus, the depreciation rates approved in Docket No. 2001 already take into consideration the burning of substitute fuels.

The examiner believes that HL&P's proposed depreciation rates should be adopted here. These rates were supported by staff witness Lee, who is an expert on the issue at hand, and has been involved in previous HL&P cases. Furthermore, the examiner believes that the rates were changed in Docket No. 2001 due not only to the Power Plant and Industrial Fuel Use Act, but to other circumstances which still exist today, as mentioned previously.

B. Construction Work in Progress (CWIP)

1. Rate Base Treatment

HL&P requested the inclusion in rate base of 100 percent of test year CWIP, ($959,955,000) in addition to 100 percent of nuclear fuel in process ($60,409,000).

All witnesses testifying on this issue agreed with HL&P's inclusion of 100 percent CWIP and NFIP, with the exception of DOE witness Marshall, who recommended an allowance of 50 percent of CWIP and NFIP.

HL&P contends that 100 percent of CWIP and NFIP must be included in rate base if the financial objectives HL&P consider necessary for satisfactory financial performance are to be met. These objectives are set forth below:

1) Generation of a minimum of 40 percent to 45 percent of construction requirements from internal sources;

2) Ability to sell common stock at or above book value;

3) Achievement of a pre-tax interest coverage, excluding AFUDC, of not less than 3.5 times.

4) Maintenance of a capital structure of 45 percent common equity with debt less than 50 percent; preferred stock makes up the difference.

5) Limitation of the percentage of AFUDC to income available to common to a level consistent with achieving the objectives listed above.

HL&P stated that its financial objective of a minimum of 40 percent to 45 percent internally generated funds reflects a realistic appraisal of the constraints of external financing. As the high level of construction expenditures places pressure on the company's position, investors recognize that additional external financing is necessary. HL&P contends that a pre-tax interest coverage ratio of not less than 3.5 times is required if a double A rating is to be realized. The targeted capital structure was developed in response to the increased risk associated with electric utility operating environments in general, high interest rates, volatile financial markets, economic uncertainty and the company's construction requirements. It is also argued that the AFUDC component of earnings must be limited to a level which will still allow the utility to generate a sufficient level of its capital requirements internally.

Staff set its financial integrity parameters by looking closely at the near-term financial outlook for the company, in particular its ability to attract capital at reasonable rates and continue with its construction program in an orderly fashion.

Staff witness Jeffrey L. Nash testified that HL&P faces only slightly lower demand growth in the near future. In addition, it is continuing to diversify its fuel mix away from natural gas and oil. Consequently, Mr. Nash considered HL&P's large construction program to meet this increasing demand and to convert to alternate fuels. Specifically, Mr. Nash noted that the company's annual capital budgets for the years 1982 through 1984 show the company will need to raise nearly $2.0 billion in external funds.

Mr. Nash's targeted financial indicators are:

1) AFUDC should be no more than 20 to 40 percent of income available to common.

2) Pre-tax interest coverage, excluding AFUDC, should be in the range of 3.0 to 3.5 times.

3) Internally generated cash should be no less than 40 percent.

Cities' witness Jane K. Wilton developed guidelines in making her CWIP decision which included what she characterized as the company's "mammoth" construction program. Her guidelines follow:

1) Internally generated cost should be approximately 35 percent;

2) Pre-tax fixed charge coverage should be approximately 3.0 times, and

3) AFUDC should be no greater than 30 percent of income available to common.

TNP witness Robert L. Krause used the same computer model that Mr. Nash utilized in his study. The

projected financial budget of HL&P for calendar year 1983 was inputted into the program, and Mr. Krause's own choices for appropriate financial guidelines were also used. These guidelines are:

1) AFUDC should be in the range of 20 to 40 percent income available to common;

2) Pre-tax interest coverage, excluding AFUDC, should be in the range of 3.0 to 3.5 times;

3) Internally generated cash should be no less than 40 percent.

DOE witness Marshall "tested" his 50 percent of CWIP and NFIP recommendation against test year data. Resulting financial indicators were:

1) Interest coverage

excluding AFUDC	4.18x
including AFUDC	4.50x
2) Cash coverage of common dividends	3.36x
3) Internal cash generation	49.5%

Financial integrity is a prospective concept unique to each company taking into account its outlook and future needs. The examiner agrees with the majority of witnesses testifying on this issue that 100 percent of CWIP and NFIP must be included in rate base if HL&P's financial integrity is to be maintained, and if HL&P is to have the ability to secure the unprecedented amount of external financing it needs, as set forth below:

	($ millions)				
	1983	1984	1985	1986	1987
Total Capital Requirements	$1,136	$1,300	$1,316	$1,496	$1,471
Funded Externally *	$ 682	$ 780	$ 790	$ 898	$ 883
Common Stock	200	200	220	220	220
Preferred Stock	100	100	110	110	110
Debt and Other	382	480	460	568	553

* Assumes 40 percent of capital requirements funded through internal sources.

Staff, Cities and TNP argued that HL&P's financial indicators at present are strong even for a AA rated utility. At the hearing, Staff introduced evidence to show that HL&P's proposed indices are above those cited as average by Standard and Poor's for a AA utility. HL&P's response is that it is obviously not considered an average AA utility. It was downgraded in November 1981 to an A+ rating because of the size of its construction program and the difficulties encountered at the South Texas Nuclear Project.

The examiner has concluded, based on the evidence presented on the issue of financial integrity, that HL&P's indicators have been set to achieve an upgrade in the utility's rating and to move toward a unity relationship on the market-to-book ratio. Because the examiner believes that the goals underlying the HL&P financial target levels are designed to go beyond maintaining HL&P's strong financial position which exists today, somewhat more moderate indicators, such as those suggested by witness Nash, are preferable, especially when taking into account the level of support that ratepayers can realistically be expected to provide to HL&P at this time.

The financial indicators set forth below are those generated by the examiner recommended revenue requirements for HL&P.

The indicators for 1982 are low because of the impact of the write-off for financial purposes of the non-recoverable portion of ACNP. (See Section XIII, G.) According to HL&P witness Campbell, any amounts not recovered through rates would have to be immediately written off against income. In this regard, the examiner is aware that the 1982 indicators fall below those recommended by staff as reasonable targeted levels. However, it must be kept in mind that the examiner has already undertaken to insure financial integrity in this docket through the inclusion of 100 percent CWIP-NFIP and the setting of an adequate overall rate of return. The reason that the targeted financial indicators cannot be met in 1982 has to

do with an issue entirely unrelated to financial integrity and targeted financial levels, i.e., the issue of accountability of HL&P management to its stockholders and ratepayers in relation to Allen's Creek Nuclear Project (ACNP). If the findings on ACNP are to have any impact, the indicators, as undesirable as they may be, should be left standing. It must also be noted that the indicators for 1983, the period during which the rates in this case will be in effect, improve substantially, and should ensure maintenance of HL&P's current credit rating and financial integrity.

	1982E	1983E
Internal Cash Generation	26.1%	36.7%
AFUDC as a Percentage of Income Available for Common	59.2%	19.2%
Interest Coverage Excluding AFUDC	2.41x	3.23x
Interest Coverage Including AFUDC	2.90x	3.49x

2. W. A. Parish Plant Modifications

Staff proposed that construction work in progress (CWIP) be reduced by $12,256,000, to reflect the dollar expenditures that have been made to modify the Parish Coal Units. There is pending litigation between HL&P and the coal supplier. It is staff's contention that until this litigation is settled, either in the courts, or by negotiation, these expenditures should not be reflected in CWIP, but should be recorded as a deferred debit.

The reason for these expenditures is that HL&P has experienced certain air pollution problems with its coal plants. As a result, the coal units have to be modified.

HL&P argued that Ms. Neff's adjustment was without justification in the record and that pollution control is an important problem with coal plants that may require various modifications.

The examiner agrees with staff's treatment. Staff does not take the position that the approximate $12 million should be denied to HL&P, only that the expenditures should be booked as a deferred debit while litigation is pending. HL&P may recover in its lawsuit for the retrofit expenses; there is no reason cited to the examiner why ratepayers should pay a return on the amount sought in the lawsuit in the meantime.

3. W. A. Parish Unit No. 8

HL&P reclassified W. A. Parish Unit No. 8 from CWIP to Account No. 106, Completed Construction Not Classified—Electric, and included the reclassified amount in rate base. DOE objected because the plant is not scheduled for commercial service until 1983. The unit is scheduled to go into service at about the time new rates are expected to go in effect.

DOE witness Marshall stated that he knew of no assurance that the plant will come on line at the time new rates resulting from this case will become effective.

The completion of Parish No. 8 appears to be proceeding on schedule. The examiner does not agree with DOE's position, which, in effect, would cause HL&P to wait until its next rate case to include this investment (approximately $334,000,000) in rate base. Therefore, it is recommended that DOE's adjustment not be adopted.

C. Property Held for Future Use

DOE, CCRR, TNP and staff decreased HL&P's Electric Plant Held for Future Use (PHFU) in the amount of approximately $17,777,000, which represents properties that are not scheduled for use prior to 1993, and which properties allegedly have no scheduled "used or useful" date.

The general rule concerning property held for future use is that it is unreasonable to require the ratepayers to pay a

return on property that will not be placed in service for ten years. However, where extenuating circumstances prove it reasonable, property not to be used within ten years might still be properly included in a company's invested capital.

HL&P demonstrated no unusual circumstances in this case, and therefore, the $17,777,000 adjustment should be made. This adjustment is consistent with treatment accorded PHFU in previous HL&P rate cases and other electric utility cases before this Commission.

D. Working Capital

HL&P, staff, and Cities used the one-eighth formula as authorized by P.U.C. SUB. R. 052.02.03.031(3)(A)(B)(C), which follows:

> (3) Working capital allowance to be composed of but not limited to the following:
>
> (A) Reasonable inventories of materials, supplies and fuel held specifically for purposes of permitting efficient operation of the utility in providing normal utility service (e.g., excludes appliance inventories);
>
> (B) Reasonable prepayment for operating expenses; and
>
> (C) A reasonable allowance up to one-eighth (1/8) of total annual operations and maintenance expenses, excluding allowance for (A) and (B) above. Operations and maintenance expenses do not include depreciation, other taxes or federal income taxes. The amount of operations and maintenance expense may be reduced for fuel expense, depending on the method of passing fuel cost to the consumer and for other items.

DOE witness Marshall performed a fully developed lead-lag study using data provided by HL&P and the Arthur Anderson lead-lag study. Based on HL&P expense levels for the test year, Mr. Marshall determined that the one-eighth formula provides cash working capital in excess of HL&P's requirement in the amount of $69,931,000 on an average annual basis. DOE submits this amount is rate-payer-supplied cost free capital, which must be subtracted from rate base.

Mr. Marshall relied on an Arthur Anderson study prepared in August, 1982, for the City of Houston which states that HL&P experiences an average lag of 36.93 days in the collection of revenues.

He subtracted the average revenue lag days of 36.93 from the disbursement lag days of 45.445 implicit in SUB. R. 052.02.03.031 to arrive at the conclusion that HL&P would receive cash working capital from its customers 8.5145 days before it makes disbursement under the one-eighth formula.

In designing his own cash working capital formula, Mr. Marshall removed all major non-cash items (depreciation and amortization, nuclear plant cost, deferred taxes and investment tax credits) from the Arthur Anderson study and removed "return", but included interest expense. His final recommendation was that cash working capital be calculated in this case according to certain formulae set forth below:

Item	Expense Level	Percent	CWC
(a)	(b)	(c)	(d)
Fuel		1.1315%	
Purchased Power		0.7226%	
O&M		3.3041%	
Income Taxes—Current		14.7589%	
Interest Expense		14.0219%	
Total		14.5397%	

For each line, (b) × (c) = (d). The sum of Column (d) is the cash working capital allowance. Since the percents, above, are simply the difference in revenue and expense lag days divided by 365 days, they can be used with any expense levels obtained by the Commission.

The examiner recommends adoption of the traditional one-eighth formula. This formula has been used consistently in rate cases filed with this Commission and should not be abandoned based on an expert's opinion which is itself based on a study that has not been proved to be of any validity on the record. Indeed, the Arthur Anderson study was not relied upon by the City of Houston, for which it was commissioned, nor by staff. The examiner has reviewed that study, and noted that it contradicts its own findings of 36.93 lag days at pages 5 and 6 of its summary:

> In summary, the lead-lag study showed that for the as adjusted test period ended March 31, 1982, the investors will have supplied an estimated net capital amount of $40,754,000, which is necessary to finance the entire cost of service for the period of time between the rendention of service and receipt of payment from customers. It should be noted that this method of cash working capital allowance determination is an estimate of the net investor supplied capital outlay assuming that Houston Lighting and Power Company could provide cash from investors precisely when needed and could use cash received from ratepayers precisely when received. However, from a practical standpoint, Houston Lighting and Power Company must maintain certain amounts of cash and working funds on hand in addition to the amounts of "cash working capital" ($40,754,000) shown to be necessary by the lead-lag study. Consequently, adding the average balance of cash and working funds of $9,366,000 (as shown in Houston Lighting and Power Company's rate filing) to the results of the lead-lag study would indicate an

estimated overall cash working capital of $50,120,000. This compares with Houston Lighting and Power Company's cash working capital determination of $47,249,000, using the one-eighth formula approach. (Report, attached to DOE Ex. No. 2)

In addition to the reasons stated above, the examiner also believes that the formula derived by Mr. Marshall is overly complicated and tedious in application, and disagrees with Mr. Marshall that the non-cash items he mentions should be removed before the formula is ap-applied. To do so would seriously understate HL&P's cash needs. For these reasons, and those noted above, the examiner recommends that the use of the one-eighth formula be adopted in this case.

E. Prepayment Adjustments

Staff reduced the prepayment balance requested by HL&P by $1,667,000. HL&P's thirteen month average of prepayments included state gross receipts tax and an ad valorem tax. Staff took the position that neither of these types of taxes are prepaid taxes and should not be recorded as such. The state gross receipts tax is based upon revenues received in a quarter prior to the payment. Staff witness Neff claimed that appropriate accounting treatment would dictate that these amounts be accrued and set up as a current liability as opposed to a prepaid amount at the date of payment. Therefore, staff reduced the amount of prepayments by the thirteen month average of state gross receipts.

HL&P also recorded certain ad valorem taxes as prepayments. After review of the invoices and review of agreements between the company and the taxing authorities, staff was of the opinion that these were not prepaid taxes and should not be included in prepayments.

HL&P argued that these payments are made in advance as payments for the right to do business. The fact

that the calculation is based on historical receipts has nothing to do with the advance nature of the tax payment.

The examiner agrees with staff's interpretation of these tax responsibilities, and believes that staff's proposal that the amounts be accrued and set up as a current liability is proper. Therefore, it is recommended that staff's adjustment be adopted.

F. Deferred Tax Accruals—Freestone and Allens Creek Unit No. 2

HL&P removed the dollar amounts of deferred taxes related to the unamortized balances of Allens Creek Unit No. 2 and the Freestone Unit and deferred charges that were ordered to be amortized in prior dockets. HL&P's contention is that since these items were not given carrying costs, it would be inappropriate to deduct the deferred taxes from invested capital.

Staff argued that since the company was given the deferred tax dollars through the cost of service on these items, these tax dollars provide cost free capital to HL&P until such time as the deferred taxes are completely reversed. Therefore, staff included the deferred taxes in its deductions from invested capital. The cities proposed the same adjustment.

The examiner agrees with staff that these tax dollars provide cost free capital to HL&P and should be treated as such until the deferred tax entries are completely reversed.

G. Gable Street Plant Site

Cities proposed the removal of the land at the Gable Street plant site from plant in service (HL&P included the retirement of that plant in 1983 as part of its rate filing package). HL&P argues that the switchyard and substation existing at that site will remain in service

as a necessary part of its distribution system in downtown Houston.

Since the substation will remain in service, Cities' adjustment should be rejected.

H. Inventory Adjustment Reserve

Cities' witness Winkelmann proposed a reduction to the inventory adjustment reserve. HL&P witness McClanahan testified that the balance shown on Schedule G-1, Column e, of materials and supplies are all net figures from which an inventory adjustment reserve has already been deducted.

The Cities' adjustment appears to be the result of a misunderstanding, and should be rejected.

I. Other Cost Free Capital

Staff increased other cost free capital by $3,619,000 to deduct from invested capital the accrual for payment of taxes to Dickinson Independent School District. HL&P is currently involved in litigation with the taxing authority of Dickinson Independent School District. The company has continued to record an expense and a liability even though the amount of the taxes are still in litigation. Staff argues that until such time as the litigation is settled, the accrual for payment of these taxes should be deducted from invested capital. Staff's dollar amount was determined by taking the balance from the prior docket for HL&P and adding the dollars expensed during the test year.

HL&P argued that the proper amount to be deducted is $943,000, the amount suggested for deduction from invested capital by the Cities. Ms. Neff's figures came from a request for information directed to Dickinson Independent School District. HL&P claims that the District's

answer to staff's inquiry lumped both taxes and accrued liabilities together.

Staff's calculation does not appear incorrect and should be adopted.

IV. Recommendation—Invested Capital

Based on all of the above, a total invested capital figure for HL&P is derived, as follows:

Invested Capital
(000's)

	Company Amount	Examiner Adjustments	As Adjusted
Plant in Service	$3,962,797	$ 0	$3,962,797
Accumulated Depreciation	789,536	8,129	797,665
Net Plant	$3,173,261	$(8,129)	$3,165,132
Construction Work In Progress	959,955	(12,256)	947,699
Property Held For Future Use	20,957	(17,777)	3,180
Nuclear Fuel	60,409	360	60,769
Working Cash Allowance	47,249	(2,709)	44,540
Materials and Supplies	42,257	0	42,257
Prepayments	4,934	(1,667)	3,267
Fuel Inventory	76,706	0	76,706
Less			
Deferred Taxes	324,235	5,993	330,228
Pre1971 Investment Tax Credits	8,279	0	8,279
Customers Deposits	20,695	0	20,695
Property Insurance Reserve	8,120	0	8,120
Other Cost Free Capital	18,246	3,619	21,865
Total Invested Capital	$4,006,153	$(51,790)	$3,954,363

V. Current Cost of Plant Service

In calculating current cost, HL&P followed accepted trending methodologies in evaluating the replacement cost new of its plant in service. Staff witness Lee noted that HL&P proposed the use of the trended theoretical reserve method, which has been consistently recommended

in previous cases. He testified that this method complies with P.U.C. SUB. R. 052.02.03.031(e). The examiner agrees with Mr. Lee that the company has properly calculated its current cost figure of $6,015,220,000.

VI. Adjusted Value of Invested Capital

Section 41 of the Act provides that the adjusted value rate must reflect a balance of between 60 and 75 percent original cost less depreciation and between 40 and 25 percent current cost less an adjustment for age and condition. In determining the proper weighting of current and original costs of property, HL&P considered the effects of inflation on its construction program, the growth of its service area, the quality of service currently being provided to its customers, and its need to attract new capital to finance its construction costs. Inflation will especially effect HL&P's construction program due to the length of time required for completion of major construction projects. Because of these factors, HL&P determined that a mix of 40 percent net current cost and 60 percent net original cost is necessary and appropriate to accurately reflect the adjusted value of utility property used by and useful to its customers. The City of Houston and Coalition also used these figures.

Staff developed its adjusted value of invested capital under the assumption that more current costs should be included during periods of high inflation and deflation, and more original cost should be included during periods of low inflation and deflation. This approach takes into account two aspects of the adjusted value of invested capital. First, the impact of past inflation (deflation) on the company is accounted for by means of trending the original cost of the company's property. The resulting net current cost is directly determined by the age of the property and by the inflation (deflation) that has

taken place up to the present. Second, the balance between net original and net current cost reflects the current annual rate of inflation or deflation. Thus, the present state of the economy is used to weight the extent to which past inflation and deflation are taken into account.

The mix between net current cost invested capital and original cost invested capital was determined so that the statutory limits for inclusion of net current cost coincide with historical experience of price level changes. Over the 34 years period from 1947 to the present, the most extreme inflation or deflation rate was the 11.8 percent inflation in 1947; therefore, 12 percent was selected by staff as the outside limit. These boundaries have been linearly connected with the origin under the presumption that, in the absence of either inflation or deflation, the invested capital mix should reflect 25 percent net current cost and 75 percent net original cost. According to staff, for each additional percent of inflation or deflation, an incremental 1.25 percent of net current cost should be included in the invested capital mix.

Staff used a current deflation rate of 7.7 percent to arrive at the balance between net original and net current cost of invested capital.

As reported in *National Economic Trends*, prepared by the Federal Reserve Bank of St. Louis, the seasonally adjusted annual inflation rate (based upon the Gross National Product Implicit Price Deflator) for the year ending March 31, 1982, was 7.7 percent. Staff selected this time period so as to conform to the test year and to be reasonably representative of the present state of the economy. Staff arrived at a mix comprised of 34.625 percent net current cost, and 65.375 percent net original cost investment.

Because the methodology of staff has been consistently applied by the Commission in previous cases, and since

it is an approach which considers the inflationary effects which the adjusted value of rate base is designed to recognize, the examiner recommends use of staff's proposed ratio. This results in an adjusted value for HL&P's invested capital of $4,941,200,000, as set forth on Exhibit II, attached.

VII. Capital Structure

HL&P made two adjustments to the test year end capital structure, the first to increase long term debt by $125 million to incorporate the issuance of first mortgage bonds at an estimated stated rate of 15 percent. These bonds were to be issued the week of August 16, 1982. The second adjustment was for stock issued in April 1982, with net proceeds to HL&P of approximately $84 million.

Cities' witness Wilton suggested inclusion of both issues. Staff included only the stock issuance.

Staff's position is proper. The hearings in this case began August 30, 1982. The issuance of the debt proposed to be included took place at least five months beyond the end of the test year. The inclusion of this debt without considering its effect on taxes and financial integrity would be inappropriate.

Based on all of the above, the proper capital structure for HL&P is as follows:

Weighted Average Cost of Capital
(000's)

	Amount	Percentage
Long-Term Debt	$1,903,042	45.06%
Preferred Stock	243,518	5.77%
Common Equity	1,795,597	42.51%
Accumulated Deferred Investment Tax Credits	281,393	6.66%
Total	$4,223,550	100.00%

VIII. Rate of Return

A. Introduction

HL&P, staff, and Cities presented testimony to the fair rate of return of Houston Industries Incorporated (HII), and HL&P. All witnesses generally agreed that, given the extent to which HL&P dominates the financial performance of HII, and because the common equity of HL&P is not publicly traded, (HII is the parent company and sole owner of HL&P's common equity), the fair rate of return on equity for HII may be imputed to be the fair rate of return on equity for HL&P.

HL&P's witness, Steven F. Sherwin, testified that the allowable return on common equity should be 17.50 percent. Staff witness Jeffrey L. Nash recommended a rate of return on common equity of 16.85 percent. Cities' witness Jane K. Wilton proposed an allowable level of earnings on HL&P common equity of 16.95 percent.

B. HL&P's Analysis

HL&P's witness Steven F. Sherwin considered four separate tests in arriving at his cost of common equity capital: comparable earnings, financial integrity, capital attraction, and debt-equity risk premium.

The comparable earnings technique seeks to estimate the return requirement in relation to earnings on book equity of other companies whose risk characteristics are similar to those of public utilities. In selecting a period for measuring returns that may reasonably be expected to be achieved in the future, Dr. Sherwin relied on three and five year periods ending 1981. In selecting samples of industrial companies with reasonably similar investments risk, he focused on what security analysts have traditionally regarded as the most important investment characteristic associated with utilities: stability of returns. He selected two samples, the first sample compris-

ing forty companies was selected from six "stable" industries; the second sample, comprising seventy-six industrials, was selected from all industries. The returns of the first samples for the last three and five year periods were 15.9 percent for the years 1979 through 1981, and 15.8 percent for the years 1977 through 1981; for the second sample, a return of 15.9 percent for the years 1979 through 1981, and 15.8 percent for the years 1977 through 1981, was calculated. Dr. Sherwin concluded from his analysis that the returns of industrials of reasonably similar investment risk to electric utilities should be in the range of 15.75 to 16.75 percent. However, Dr. Sherwin noted that the comparable earnings test has always looked to returns that may be experienced in a "normal" year. Because the current recession was figured into Dr. Sherwin's analysis, he stated that the lower end of the range of numbers referred to above reflects the assumption of a slow recovery from the recession. The upper end of the range reflects the more optimistic projection of rising returns with higher economic growth.

Dr. Sherwin noted that the financial integrity test relates to allowing utilities levels of earnings that permit the achievement of appropriate market-to-book ratios, so that the sale of new equity does not impair the previously committed capital. He stated that if the market price of a utility stock remains below book value for a long period of time, it constitutes prima facie evidence of the inadequacy of earnings and the impairment of capital. Dr. Sherwin felt that an appropriate target market-to-book ratio is that achieved by industrials of similar risk to utilities, which have averaged 100-120 percent in the three- and five-year periods ending 1981. According to Dr. Sherwin, HII has not been able to maintain its financial integrity since 1977 because the market price of its stock has been below book value in every quarter, with one exception, for more than four years. He felt

that the company's integrity had not only been impaired, but the degree of impairment had increased recently, as indicated by the decline in the market-to-book ratio to an average of 80 percent in the last two years.

Dr. Sherwin also undertook an analysis of the relation between returns and market-to-book ratios, comparing HII and selected samples of industrials. This analysis showed that investors perceive HII as relatively more risky than the selected sample of industrials. Dr. Sherwin blamed the perception of more risk on the delay in the completion of South Texas Nuclear Project, HL&P's declining reserve margin, and the high level of construction expenditures which would be necessary in the future to meet HL&P's needs. Because of this higher perception of risk, Dr. Sherwin testified that it follows that the required return to achieve a similar market-to-book ratio lies above the 15.75-16.75 percent returns suggested by the comparable earnings test. According to him, the relatively higher risks call for an upward adjustment of approximately 1.0 percent to the results of the comparable earnings test.

The discount cash flow techniques seeks to infer investor capitalization rates from stock market data by reference to dividend yield and prospective growth in dividends and is generally represented by the following formula:

$$k = \frac{D_1 + g}{P_0}$$

For price, Dr. Sherwin used the highest price in the fifty-two weeks ended May 20, 1982, or $21.75. The dividend was calculated at $2.16, the current dividend rate. Dr. Sherwin projected the 1982-83 yield for HII in the range of 10.0-11.0 percent.

To estimate the growth rate, Dr. Sherwin reviewed annual growth rates in HII's earnings, dividends and

book values, which showed wide fluctuations from one year to the next; he concluded these rates permitted no reasonable inference as to investor expectations. Compound ten-year dividend growth rates, computed on the basis of least squares for successive periods, show a distinct upward trend, from 7.1 to 8.9 percent. The growth rates in book value show a declining trend from 8.2 to 6.9 percent. Dr. Sherwin concluded that a longer-term growth rate for HII's total operations is in the range of 7-7.5 percent, but that the growth rate for utility operations is approximately 6.5 percent.

Based on a projected dividend yield of 10.0 to 11.0 percent, and a growth rate of 6.5 percent, he estimated the current "bare-bones" cost of capital at 16.5-17.5 percent, or a mid-point of 17.0 percent, excluding financing and market pressure cost. He felt the 17.0 percent "bare-bones" cost was conservative, not because of any intention to understate cost, but rather due to the fact that it incorporates a downward adjustment to the growth rate for the impact of diversification on HII's total profitability, without making any upward adjustment to the dividend yield portion.

Dr. Sherwin used 3.0 percent as representative of prospective conditions for the cost of financing. He estimated a prospective market pressure at 3.0 percent. Thus, the sum of financing cost and market pressure was estimated at 6.0 percent. Based on a dividend yield of 10.0-11.0 percent, a flotation cost allowance of 0.6-0.7 percent, and a growth rate of 6.5 percent, as calculated above, Dr. Sherwin concluded that the estimated prospective cost of capital was in the range of 17.1-18.2 percent.

C. Staff Analysis

As the first step in estimating HII's cost of equity, the returns earned on book equity by other firms in similar risk categories were evaluated by Staff witness Jeffrey L. Nash. Mr. Nash noted that for this methodology to be

useful in identifying investors' required returns, it must be assumed that other companies, on average, have earned their cost of equity on net book value. Furthermore, it must be established that the risks to the stockholders of the other companies selected for comparison are similar to the risks of owning HII's common stock. Mr. Nash measured this risk to the HII investor with two of *Value Line's* statistical measures, first by the company's Beta, and second, by the company's *Value Line* price stability index.

Mr. Nash's Beta analysis showed that firms with adjusted Betas of .64 to .75, (*Value Line* has assigned HII a Beta of 0.70) earned an average of 14.6 percent during the most recent five-year period, 1976 to 1980, 14.6 percent between 1979 and 1980, and 14.3 percent over the fifteen-year period 1966 to 1980.

Value Line has assigned a price stability index of 95 to HII; the index ranges from one hundred (least risky) to five (most risky). Using identical computational models and similar grouping procedures as in the Beta analysis, Mr. Nash found that firms with price stability indices comparable to HII's realized a 15.8 percent return on average book equity between 1976 and 1980, 15.6 percent between 1971 and 1980, and 15.4 percent during the 1966 to 1980 period.

Mr. Nash testified, however, that several drawbacks exist with the comparable earnings analyses of this type. First, he felt that the basic assumption upon which the test is founded (that on average, companies realize the cost of equity on book value), must be seriously questioned. Additionally, he felt that there was no assurance that a set of comparable companies can be picked, given the rapid evolution of industry and market factors today. In a similar vein, Mr. Nash testified that it is disconcerting to note that there is little relationship between bond yields and the returns realized over the fifteen year period 1966 to 1980. If returns on book

equity across all stocks were truly reflective of the cost of equity, one would expect to find a much stronger apparent relationship between a required return from bonds and the realized book returns. Most importantly, Mr. Nash felt that relying on returns that have been earned in the past under varied financial and economic conditions fails to recognize the current nature and market orientation of equity investors' required rates of return. For these reasons, Mr. Nash questioned the validity of this type of comparable earnings test.

Mr. Nash also utilized the dcf formula. He testified that the dividend yield component of the dcf model should be computed by dividing the dividends expected to be received in the coming year (D_1) by the current market price (P_0). He used the final two quarters of 1982 along with the first two quarters of 1983 in the determination of HII's dividend yield. He noted that HII's present quarterly dividend is $.54. Therefore, to determine the appropriate projected 1983 quarterly dividend to employ, Mr. Nash used the company's suggested expected 1983 quarterly dividend increase of $.05. Mr. Nash conservatively employed an estimated $.04 increase in 1983 quarterly dividends to arrive at a D_1 of $2.24 (two quarters at $.54 and two quarters at $.58).

In arriving at a market price, Mr. Nash noted that HII's stock has ranged from $18.00 to $20.13 over the last weeks before the hearing in this case so that a price of $19.00 was used in his analysis. He selected this recent market price because the cost of equity is a current and forward-looking concept, and a recent market price is a better indication of investors' present requirements than would be a historical point estimate (such as end of test year, or a long-run average). Based upon an expected dividend of $2.24, and the recent market price of $19.00, the market presently expects a dividend yield of approximately 11.78 percent from Houston Industries.

Mr. Nash's market-to-book adjustment was approximately 5 percent, which he felt should be sufficient to encourage the desired market-to-market ratio. Thus, his adjusted dividend yield for HII was 12.35 percent.

Mr. Nash used two methods in estimating HII's expected growth rate. First he performed a general review of information upon which investors might rely in forming their expectations for HII's future. The internal growth expected from earnings retention and long-term earned rates of return were evaluated and then historical growth rates, dividends, and the earnings and book values that support dividend growth were examined. In addition, Mr. Nash also discussed additional industry and economic considerations that may affect investors' perceptions of HII's long-term future prospects.

Mr. Nash's analysis indicated to him the likelihood of a reduction in growth expectations by investors. Support of this presumption, he stated, is found in the market for HII's stock. According to Mr. Nash, since this time a year ago, HII's stock has shown no price appreciation, suggesting investors have re-evaluated the company's stock and are demanding more of their return through a higher dividend yield as they expect dividend growth to slow. Mr. Nash noted that this time one year ago his analysis in Docket No. 3955 showed a dividend growth rate to be in the upper end of 4.0 to 5.0 percent range. This year, however, he has lowered his estimate of HHI growth to the mid-point range of 4.0 to 5.0 percent or 4.5 percent.

Employing the adjusted dividend yield of 12.35 percent, and a 4.5 percent mid-point of its expected growth range, a determined rate of return on equity of 16.85 percent was derived by Mr. Nash.

After considerable analysis, Mr. Nash discarded the risk premium analysis, because spreads between bond and stock returns based on historical data were not found to be reliable.

D. Cities' Analysis

Ms. Wilton also rejected the risk premium analysis noting that literature varies on the subject, but that there is present strong contention that little, if any, premium exists on the expected return on a common equity investment over that of a bond investment for a given firm.

In her dcf analysis Ms. Wilton used a 54 cents quarterly dividend as declarable on December 10, 1982, and projected 1983 dividends to be 58 cents. Therefore, the level of dividends used in her dcf analysis included two quarters in 1982 at 54 cents and two quarters in 1983 at 58 cents for a total of $2.24. The stock price used by Ms. Wilton was $18.25 per share which she testified closely approximated the average of the closing prices for the month of August. According to Ms. Wilton, based on an expected dividend of $2.24, and an $18.25 current stock price the market is presently expecting a dividend yield of approximately 12.27 percent from HII's common stock equity.

Ms. Wilton estimated market pressure to reflect the average of the range of market pressure experienced with the last three issues of HII stock, or 2.8 percent. She also allowed for issuance expenses of approximately 2.69 percent. Her resulting adjustment to dividend yield was 1.0549 percent, to result in an overall dividend yield, as adjusted, of 12.95 percent. For her growth rate, Ms. Wilton used 4 percent, which was based on growth in kilowatt hour sales, service area population, system demand, and system peak demand expected growth rates, as well as the earnings compounded growth rate for the five years ended December 31, 1981 for HII of 3 percent. Based on all of the above, Ms. Wilton's overall recommended rate of return for common equity was 16.95 percent.

E. City of Lake Jackson

The City of Lake Jackson presented the testimony of Mr. Charles Golden, a chemical engineer, who is also a member of the Lake Jackson City Council. Mr. Golden suggested that a return on equity of 15.62 percent is reasonable.

In determining this rate of return, Mr. Golden examined the rate of return of all electrical utilities in the United States, other regulated industries, and other capital intensive industries. He also felt it improper to include in the cost of equity the effects of financing and market pressure.

F. Summary and Recommendation on Rate of Return

For the reasons stated below, the examiner is of the opinion that staff's recommendations in this case are the most reasonable, and should be adopted by the Commission.

The examiner believes that a comparison of testimony and exhibits presented by the witnesses in this case shows that Mr. Nash's dividend yield calculations and growth projection are supported by a wider range of more accurate and theoretically acceptable considerations than those presented by other witnesses on this issue.

Mr. Nash's choice of market price and expected dividend were based on sound analysis and preferable to the other witness' choices, but the real dispute in this case revolves around the calculation of "g". As already discussed, witnesses Nash and Wilton arrived at comparable growth rates of 4.5 to 4.0 percent, respectively, while HL&P witness Sherwin used a growth rate of 7.0 percent.

The examiner agrees with staff and Cities that Dr. Sherwin's figures are excessive. His reliance on an his-

toric growth rate was improper because annual growth rates of HII's earnings, dividends and book values show wide fluctuations from one year to the next. Because of these wide fluctuations, no easy inference of investor expectations can be derived.

Mr. Nash's analysis is preferable to others presented because of the appropriate factors he took into account in deriving his 4.5 percent growth factor. For example, while Mr. Nash concedes that historic growth has been greater than 4.5 percent, he noted that this growth has been accomplished only by paying out a larger percentage of earnings each year. (The earnings retention rates have consistently gone down from a level of 60 percent in 1976 to 37 percent in 1981.) Witness Nash also pointed out that earnings for HL&P have been flat. If these earnings continue to be flat or show only moderate growth, and if HL&P is forced to retain more earnings to support its construction program, then it is logical to expect a lower growth in dividends.

Mr. Nash also took into account the fact that earnings were up in 1982 only because funds were not expended by HL&P for the South Texas Nuclear Project. With a new, accelerated schedule for the project, Mr. Nash concluded that investors will be forced to assume that future dividends will be restricted. He also correctly concluded that the rapid rise in inflation coupled with the rapid growth in dividends since 1976 reflects the desire of investors to use dividends as an inflation hedge. As inflation has slowed in recent months, so also dividend growth is expected to slow.

The examiner believes Staff's figure more accurately depicts what will occur in growth rates over the period these rates are in effect. Mr. Nash's 16.85 percent recommendation squares with the bottom end of Dr. Sherwin's comparable earnings test, which the examiner considers reasonable for a regulated monopoly competing for capital with non-regulated, high-grade industrial concerns.

Although the debt/equity risk premium test was essentially discarded by witnesses Nash and Wilton, the examiner's recommendation, it should be noted, also falls at the lower range of Dr. Sherwin's risk premium test. Overall, a return on common equity of 16.85 percent fairly reflects the risks of investing in HII, and should be adopted by the Commission.

Thus, an overall weighted cost of capital of 12.63 percent is recommended, as shown below:

Weighted Average Cost of Capital
(000's)

	Amount	Percentage	Cost	Weighted Cost
Long-Term Debt	$1,903,042	45.06%	9.19%	4.14%
Preferred Stock	243,518	5.77%	8.23%	.48%
Common Equity	1,795,597	42.51%	16.85%	7.17%
Accumulated Deferred Investment Tax Credits	281,393	6.66%	12.63%	.84%
Total	$4,223,550	100.00%		12.63%

IX. Economic Adjustments—Stipulation

The majority of parties stipulated to staff's adjustments to HL&P's test year megawatt hour sales. It was agreed upon by all parties participating in this case, except Dow, that megawatt hour sales of 57,216,206 MWH should be used as MWH billing determinants and should be allocated according to the schedule set forth on Exhibit III, attached to this Report. It was also agreed that test year booked MWH sales should not be adjusted for the alleged changes in income during the test year, alleged gas price cross elasticity, and any alleged rate case increase price elasticity.

Dow argued that the stipulated method, which uses year-end number of customers, unfairly increases the revenue requirements of other classes and also causes projected base revenue to be understated.

The examiner is of the opinion that the stipulation is reasonable, and should be adopted. It is based on staff's testimony, which moderates HL&P's econometric adjustments. Dow's objection to the test year end customer adjustment should be ignored because Dow's suggested alternative, (adjusting for a full year's growth), is an adjustment which one might consider in the realm of a future test year adjustment. For this reason, it must be rejected.

X. Accounting Adjustments

A. Revenue Related Items

1. Fuel

a. *Fuel Mix.* Parish Unit 8 is expected to begin commercial operation at the time the rates established in this docket will come into effect. Therefore, staff changed the fuel mix to reflect an increase in coal usage and a decrease in natural gas usage.

b. *Fuel Costs-Natural Gas.* To determine the appropriate cost for natural gas as a fuel, staff's approach varied from the approach taken by the company. After an analysis of the trend of the fuel cost over the last eighteen months, the staff determined that it would be more appropriate to use the cost of natural gas at the June 1982 price level. The company's approach used test year end price levels to determine the cost of the fuel. Since the fuel cost has steadily been increasing over the last eighteen months, staff felt it was more reflective of the cost that the company will incur to use the June 1982 cost of natural gas.

In addition to adjusting the price of natural gas, staff adjusted two variables used in determining the amount of natural gas needed to generate the staff recommended required megawatt hours. Staff adjusted the MMBTU quality for natural gas by using an average MMBTU quality over a four month period, December 1981 through

March 1982. The company's approach was to use the minimum MMBTU quality per the gas contract. This has resulted in higher MMBTU's per MCF available.

The heat rate used by the company included fuel oil in the calculation. Fuel oil has a higher BTU content than natural gas; therefore, staff computed the heat rate without fuel oil, resulting in a lower heat rate. Utilizing the lower heat rate, more megawatt hours will be generated from the natural gas available.

Since the basic coal cost and natural gas cost are passed through to the customers currently, there is no need to compute those costs for the 12 months ended March 31, 1982. The staff's recommended fuel costs are totally recoverable. The effect on the cost of service, therefore, is only to increase the revenue related taxes and uncollectible expense. Based upon the review of the increasing costs, it would appear that the use of a more current cost will more closely reflect the revenue related expense that HL&P will be incurring for fuel during the period that the rates established in this docket will be in effect; staff's recommendations reflect this, and should be adopted.

2. Purchased Power

The company proposed an adjustment of $95,139,000. Of this amount $53,608,000 would be recoverable through the Fuel Adjustment Clause. In its computation, HL&P used the February 1982 fuel cost per kwh and then added .00131 per kwh for economy purchases. Economy purchases are passed directly through the fuel adjustment clause including not only the fuel charge but any O&M, and start-up cost to generate the electricity. The .00131 represents February 1982 start-up cost per kwh as a percent of economy purchases to total purchases. The capacity charge adjustment of $26,700,000 is fixed per contract. The start-up and O&M charge adjustments of $14,831,000 represent the charges that are not recoverable through the fuel clause adjustment. The February 1982

February start-up cost per kwh less the cost per kwh recoverable was used to determine this adjustment. Staff agreed with the overall approach, however, staff used test year ended March 1982 to determine the cost. This resulted in a higher fuel cost to be passed through the fuel adjustment clause. Again, it should be noted that the effect on the overall cost of service of this adjustment is merely to increase the revenue related items in the cost of service, since like dollar amounts have been adjusted through fuel revenues in the staff's calculation. The effect, therefore, on base rate revenues is simply reflective of the revenue related cost for purchased power and fuel.

B. Non-Revenue Related Items—Stipulation

All parties actually participating in the case stipulated to the following for non-revenue related expenses:

1. The non-revenue related expenses used in determining the total cost of service shall be:

	(000's)
Operation and Maintenance:	
Wage and Salary Expense	$187,359
Employee Benefits	20,978
Power Wheeling Costs	6,723
Conservation Program	7,427
Research and Development	10,951
Provision for Property Insurance	405
Amortization of Deferred Charges	719
Lease and Rental Expense	2,351
Advertising, Contributions and Donations	3,058
Legislative Advocacy	0
Social Dues	0
Rate Case Expenses	748
Other O&M Expenses	125,209
Liquid Metal Breeder Reactor Accrual	(422)
STP Litigation Legal Fees	(122)
	$365,384
Interest on Customer Deposits	1,225
Other Taxes:	
Ad Valorem Taxes	52,645
Payroll Taxes	12,294
Other Taxes	9,936
	$ 74,875

2. The factors for computing the revenue related expenses used in determining the total cost of service shall be:

Uncollectible accounts expense	.003988
State gross receipts	.009815
Public Utility Commission fee	.00158

Each factor shall be applied against the total cost of service.

3. The fuel oil inventory method shall be changed from an average cost basis to a "last in, first out" (LIFO) basis.

4. The maximum amounts which may be passed through the fuel clause for coal purchased from UFI, in accordance with the recommendations in the prefiled direct testimony of staff witnesses Marilyn Neff, Milton Lee and Jeffrey Nash, shall be:

a. The coal charge per ton shall be equal to the cost per ton of coal paid by UFI to its suppliers plus the actual rail charge per ton.

Coal Charge per ton = Coal cost per ton as paid by UFI + rail charge per ton.

b. The handling charge per ton shall be equal to the sum of UFI's actual operations and maintenance costs, administrative and general costs, and depreciation expense, less amortization of investment tax credit, divided by tons of coal burned.

$$\text{Handling charge per ton} = \frac{\text{O\&M cost + administrative and general cost + depreciation less amortization of I.T.C.}}{\text{tons burned at all coal-fired units}}$$

c. The inventory carrying charge shall be equal to the product of the weighted average inventory value (including only a 90 day maximum coal supply) and 17%, divided by tons of coal burned.

$$\text{Inventory carrying charge} = \frac{\text{weighted average inventory value with 90 day maximum coal supply} \times 17\%}{\text{tons burned at all coal-fired units}}$$

d. The fixed charge shall be equal to the product of the July 31, 1982, net asset value (net book value) of existing coal handling facilities and rail cars, less deferred Federal income taxes, 17 percent, divided by tons of coal burned.

$$\text{Fixed charge} = \frac{\text{net asset value of coal handling facilities and rail cars less deferred Federal income taxes at July 31, 1982} \times 17\%}{\text{tons burned at all coal-fired units}}$$

With respect to the inventory carrying charge, both annual tons burned and annual weighted average inventory value may be reasonably estimated monthly, so long as the actual annual weighted average inventory value and actual annual tons burned at all coal-fired units are accurately measured and appropriate refunds or charges are made through the fuel clause when the adjustments for December coal charges are passed through the fuel clause. The maximum weighted average inventory value to be used in computing the inventory carrying charge will be the weighted average inventory value of a 90 day coal supply for all coal-fired units in service, assuming a 70 percent capacity factor; provided, however, that if the actual weighted average inventory value is less than the value of a 90 day

supply at 70 percent capacity factor, then the actual weighted average inventory value will be used.

In computing the fixed charge, annual tons burned may be reasonably estimated monthly so long as actual annual tons burned are used to compute the annual fixed charge and appropriate refunds or charges are made through the fuel clause when the adjustments for December coal charges are passed through the fuel clause. Prior to Parish Unit No. 8 going into commercial operation, the net asset value of existing coal handling facilities and rail cars, less deferred federal income taxes, to be used in computing the fixed charges is $92,337,575. Once Parish Unit No. 8 goes into commercial operation, the net asset value to be used in determining the fixed charge will be increased by the net asset value of the UFI coal handling facilities and railcars, less deferred federal income taxes, associated with Parish Unit No. 8 as of the end of the month immediately preceding the first month of commercial operation.

5. The use of the injuries and damages reserve recommended in the prefiled direct testimony of staff witness Marilyn Neff will be implemented by the Company.

The stipulation is reasonable and should be adopted, with the exception of Number 4, having to do with the maximum amounts to be passed through the fuel clause. The examiner suggests that the rate of return of 17 percent for UFI's invested capital should be lowered. Although this was the rate of return adopted in Docket No. 3955, HL&P's last rate case, 17 percent appears to be an excessive number for overall rate of return. The examiner recommends that the overall rate of return for UFI be set by using UFI's capital structure as of June 16, 1982, the date this case was filed, including UFI's weighted average cost of debt at that date and an equity cost of 17 percent. This will allow a more reasonable return, and one more in keeping with traditional guidelines on return calculations.

The examiner also recommends that this formula as modified, be adopted, if at all, for a period of only ninety (90) days. HL&P should then file a tariff or request for approval of payments to affiliates along with cost information as has been done by the TU companies in Docket Nos. 4726-4728, (filed September 14, 1982). By way of explanation, on December 4, 1981, Docket No. 1903, *Application of Texas Electric Service Company for Authority to Change Rates,* IV P.U.C. Bull. 1429 (April 20, 1979) was reversed by the District Court of Travis County. The Court found that the TU companies were affiliated interests, and that this Commission could not authorize TESCO to collect from ratepayers automatically as a fuel adjustment charge payments TESCO makes to affiliated interest of amounts *which have not first been reviewed or found to be reasonable* as required by Section 41(c)(1) of the Act.

Essentially, the Court declared that affiliated fuel costs must be reviewed and found reasonable *before* pass-through to customers. Docket No. 1903 applies to the facts of this case, and the clause stipulated to by the parties violates the mandate of the District Court because it involves the use of a formula rather than the review of actual affiliated costs for reasonableness on a periodic basis. Therefore, it is recommended that HL&P prepare a tariff to be filed no later than March 30, 1983 for the purpose of setting fuel costs for affiliated interests for the period July 1, 1983 through September 30, 1983. The procedure would then repeat itself on quarterly basis.

C. Taxes

Staff's franchise fee factor was calculated using the actual amount of franchise taxes booked in the test year; the method should be adopted.

The examiner has calculated HL&P's Federal Income Tax Expense in accordance with the method used by the Commission staff using the expense items recommended in this Report.

XI Adequacy of Service

Dr. J. D. Guy, Manager of Corporate Planning at HL&P, testified that approximately 65 percent of HL&P's construction budget of $3.14 billion for the next three years will be spent on the construction of new generating units. In 1982, $767 million will be spent, $1.12 billion in 1983, and $1.26 billion in 1984.

Dr. Guy indicated that the projected annual demand growth rates over the period 1981 to 1991 are 3.0 percent and 3.7 percent, with and without load management. (HL&P hopes to shave its peak by 1200 MW by 1991 through load management techniques). The actual growth rate between 1971 and 1981 was 7.1 percent per year.

Considering the present expansion plan and the company's demand forecast, the projected system reserves, including purchased power, are expected to vary between a low of 14.5 percent in 1988 and a high of 23.4 percent in 1987. The drop in reserve margin in 1988 is due to the expiration of the existing firm purchased power contracts. (See Exhibit IV, attached, which depicts these reserve margins.)

Historically, the minimum acceptable reserve margin throughout the region designated as the Electric Reliability Council of Texas (ERCOT), of which HL&P is a member, has been 15 percent. As already noted, HL&P's expected reserves will fall below the stated minimum reserve level in 1988. Implicit in even this low reserve level are the assumptions that HL&P will keep its construction program on schedule, be successful in its load management program and conservation efforts, and attract new interruptible loads and co-generation participation.

Dr. Guy also testified that purchased power is an important part of the corporate plan in the 1980's. Exhibit IV and Exhibit V, attached, show the impact of purchased power on system reserves. For example, in 1985, pur-

chased power will make up over 68 percent of the total reserve capacity of 16.2 percent.

Even with the timely completion of HL&P's construction schedule, and the success of other programs previously mentioned, this utility will still have reserve margins which remain close to the minimum set by ERCOT.

The examiner believes that while HL&P's service is adequate at the present time, the quality of service and reliability could diminish to unacceptable levels in the near future if even one of HL&P's plans falls behind schedule. It is certainly possible that this may happen. For example, HL&P expects to shave its peak by *1200* MW in less than ten years; yet currently, only *80* MW, or approximately 7 percent of load, has been shaved. As is set forth in more detail in the examiner's discussions of the Allen's Creek and South Texas Nuclear Projects, the record in this docket indicates that HL&P may have been overly optimistic in previous future planning predictions. The examiner does not consider this a sign of mismanagement *per se*, but does believe that based on the record developed in this case concerning the history of STP, the coal-burning problem at Parish 8, the Allen's Creek cancellation, and the fact that HL&P has lost both its interruptible customers, this Commission should exercise caution in accepting at face value the company's predictions.

Therefore, the examiner recommends adoption of staff's proposal that HL&P be put on notice that if more than normal customer outages are experienced, serious consideration will be given to ordering neighboring utilities to serve existing or new customers within HL&P's certificated service area, and decertificating HL&P to those areas.

XII. South Texas Nuclear Project (STP)

A. Introduction

HL&P owns 30.8 percent of the two 1250 MW units that are under construction. The City of Austin and the City

of San Antonio together own a total of 44.0 percent; Central Power and Light owns the remaining 25.2 percent. HL&P is project manager for all aspects of STP except for the construction, operation and maintenance of the construction power line, and the 345 kv transmission line. The City of San Antonio is handling the purchase of nuclear fuel.

Initially, Unit 1 was scheduled to be in commercial operation in October 1980, and Unit 2 was scheduled to be in commercial operation in March 1982. In 1975, the estimated cost of the two units was approximately $1.4 billion, or $547 per kw. The Project Completion Forecast issued by Bechtel in August 1982 indicates commercial dates of June 1, 1987, for Unit 1 and June 1, 1989, for Unit 2. The cost of the two units is now estimated to be $5.5 billion excluding AFUDC, property taxes, and sales taxes, or $2,198 per kw. Unit 1 is now six and one half years behind schedule; Unit 2 is seven years behind schedule. Exhibit VI, attached hereto, is an excellent summary of the chronology of events at STP, from its inception to the hearing date in this case. A review of this schedule is helpful in placing in perspective the following discussion.

B. Cities' Case

Ellen Blumenthal, witness for the Cities, made the following recommendations with respect to STP:

1. The equity portion of AFUDC that has been accrued during those periods of time that construction of STP has been halted should be removed;

2. That portion of CWIP associated with STP that is not included in rate base should be identified and the accrual of the equity portion of AFUDC on that amount or on additional dollars invested in STP should be disallowed until the Commission has the opportunity to review STP in the next rate case;

3. A ceiling should be imposed with respect to expenses associated with STP of $1,692,480,000, plus the allowed

accrued AFUDC, property taxes and sales taxes which will be included in rate base when STP begins commercial operation;

4. The cost associated with the lawsuit between HL&P and Brown and Root should not be included in HL&P's cost of service, or in account 107 as a capital cost of STP; *

5. HL&P should be required to credit to the cost of STP any amount which HL&P may recover from Brown and Root as a result of the lawsuit; and

6. The recovery of any damages which HL&P may be required to pay Brown and Root as a result of the lawsuit from the ratepayers should also be disallowed.

In support of her recommendation, Ms. Blumenthal cited certain testimony and exhibits in the record from which she concluded that mismanagement played a major role in the escalation of the cost of STP from $1.4 billion to $5.5 billion. One indicator of mismanagement mentioned was the extensive delay associated with the STP because of faulty work. The first delay occurred when the NRC issued a stay work order on certain concrete placement upon the discovery of voids. The NRC delayed the concrete work in the reactor containment building walls from June 22, 1979, until September 10, 1979. The second delay resulted from the discovery of more voids in certain concrete structures. HL&P voluntarily agreed to stay work relating to concrete placement which lasted from December 28, 1979 until April 30, 1980. During that time, the NRC was conducting an on-site inspection of STP. HL&P voluntarily agreed to stop work with respect to all welding at STP in April, 1980. This halt in welding lasted until October 6, 1980, with respect to certain structural welding, and until November 21, 1980, with respect to piping welding.

On April 30, 1980, the NRC imposed a fine of $100,000 against the STP owners and issued an order requiring the

---

* This cost was excluded in the stipulation on non-revenue related items, discussed previously.

STP owners to show cause why all construction should not be stopped in 90 days. The NRC gave twenty-two reasons in its investigation for the show cause order. HL&P agreed to pay the fine on May 23, 1980. The NRC authorized HL&P to begin limited complex concrete pours on January 13, 1981. The total delay resulting from deficiencies in the construction was eleven months.

Ms. Blumenthal argued that the delays associated with construction deficiencies were attributable to the inexperience of HL&P, and its first architect, engineer, and constructor, Brown and Root (B&R). According to Ms. Blumenthal, until 1980, HL&P had few people on its staff who were experienced in the design and construction of nuclear plants. While B&R may have had personnel on staff who were experienced in the design and construction of nuclear plants, Ms. Blumethal pointed out that there was no showing that any of these people worked on STP; she felt that although B&R's employees may have had experience individually, as an organization B&R had little experience in building nuclear plants. Jerome H. Goldberg, Vice President of Nuclear Engineering and Construction for HL&P, was deposed by the Cities in this docket, and did testify that B&R had failed to perform a timely pipe break analysis outside the containment building. Dr. Goldberg attributed this failure to B&R's inexperience and insufficient numbers of knowledgeable employees.

Ms. Blumenthal concluded that the reports to management prepared by Coopers and Lybrand suggest B&R's inability to manage certain aspects of STP such as procurement of materials, inventory control, failure to pursue discounts on purchases, etc. More importantly, Ms. Blumenthal testified that these reports reveal that HL&P took no action to correct the problems which were found.

A delay of nine months from December 1, 1981 to August 31, 1982 also occurred. The cause of such delay was HL&P's removal of B&R as architect/engineer (A/E) and B&R's withdrawal as constructor. According to Mr.

Goldberg, HL&P had to relieve B&R of its position as A/E because B&R could not "bring together talent fast enough to make this job (STP) move at a rate that we felt we could afford." While Ms. Blumenthal did not challenge the decision to relieve B&R, she testified that the B&R termination could have been avoided (1) if HL&P had exercised better judgment in 1973, or, (2) if HL&P had exercised better judgment between 1975 and 1980. According to her, HL&P should have realized in 1973 that the combination of its inexperience and B&R's inexperience as an A/E would lead to the problems which it encountered from 1975 to 1982. Furthermore, between 1975 and 1980, HL&P should have realized that it needed to exert more control over B&R, which according to her, it failed to do.

Based upon this evidence of alleged mismanagement and the recognition that current ratepayers are paying for such mismanagement by inclusion of CWIP in rate base, Ms. Blumenthal urged that STP warranted special treatment in this case; therefore, a penalty/reward system for HL&P's management at STP was suggested. Details of these recommendations have been set out above.

C. CCRR

CCRR contended that all of the problems at STP were caused by a simple fact situation, as follows: a utility company with an inexperienced and undermanned nuclear engineering staff hired an inexperienced architect-engineer to construct a large, complex nuclear generating station in record time. In order to obtain experience by building STP, the contractor (B&R) made representations regarding duration and cost of plant construction which it could not realistically fulfill, and which the project manager (HL&P) was too ill-informed to recognize as unreasonable until four years into construction and the expenditure of $2 billion.

CCRR also alleged that HL&P did not make substantial efforts to control and manage the project until 1978, when

the South Texas Project Task Force was formed. The efforts of this task force culminated in the 1979 Baseline Study which was a comprehensive project status review and systematic effort to reforecast project cost and construction duration. However, CCRR found fault with the fact that this study did not begin until after two years of what it characterized as virtually unmonitored construction activity. Further, CCRR alleges that this fact accounts for HL&P's ignorance of the situation until 1978, at which time they discovered that actually less than 10 percent of the required design work had been completed prior to construction, instead of the 60 percent reported by the contractor. A comprehensive engineering assessment by the Company did not take place until the Quadrex Report was commissioned in 1980 by Dr. Goldberg, five years after initiation of construction.

CCRR also argued that HL&P did not attempt to manage the South Texas Project even though the owners' participation agreement stated that HL&P as project manager shall "provide for the engineering, design, . . . construction, . . . supervision, . . . expediting, . . . and inspection . . . of each component" of the project.

CCRR noted that HL&P has maintained in its lawsuit against B&R that under their agreement the contractor was responsible for project management and since B&R was an independent contractor, HL&P could only perform "programmatic oversight." Nevertheless, CCRR maintains that HL&P is the regulated utility, the plant owners' Project Manager, and the Nuclear Regulatory Commission (NRC) licensee. As licensee, the NRC recognizes HL&P's ultimate responsibility for plant safety and quality control.

According to CCRR, HL&P had the contractual right to inspect, audit and approve the contractor's work. CCRR alleges HL&P did not want to take on the responsibility of project management because it knew it wasn't

capable of performing the task and it belatedly realized that B&R could not manage the project either.

CCRR calculated the cost of delay in the project at approximately $185,000,000. According to CCRR, Cities' witness Ellen Blumenthal suggested a 600 day total delay, and HL&P witness D. D. Jordan estimated delay costs at STP at $1,000,000 a day. HL&P's share (30.8%) of this $600 million total is approximately $185,000,000; CCRR would exclude this amount from rate base.

D. Staff

Staff witness Lee testified that HL&P should not be penalized in its role as project manager at this time. He felt that HL&P should be allowed to complete construction and put the units into commercial operation before any attempt is made to draw conclusions that HL&P in its role as project manager mismanaged the projects in whole or in part.

According to Mr. Lee, when HL&P requests that this Commission include the plant in service, a more concrete and definitive position can be taken at that time, since all phases of construction can be carefully reviewed and analyzed along with the appropriate cost. From this review, if any costs are found to be unjustifiable or unwarranted, they should be excluded from the total cost of the project. Mr. Lee proposed that HL&P provide the Commission with written notice within twelve months of its expected request for inclusion of the plant in rate base. He also noted that the lawsuit between HL&P and B&R should be resolved at that point.

E. Dow

Dow argued that STP should not be included in CWIP, concluding that the delay at STP is directly attributable to project management. As Dow counsel so charmingly put it, while it is true that not all of the problems that beset the HL&P system can be laid at management's door

step, the time for HL&P to "put-up or shut-up" has arrived; Dow feels we now have a "final, final honest-to-gosh" dollar estimate on STP, and a firm estimate for time of completion, and concludes that HL&P needs to be monitored more closely, that the Commission should improve its regulatory control over construction of these massive units, and that any more delays or cost overruns should be assessed against the stockholders.

F. HL&P

HL&P focused its primary defense in this issue on the lack of management or engineering expertise of Ms. Blumenthal. HL&P's position that discussion of poor management practices can be undertaken only by one with an academic degree in management or engineering, and extensive management experience, should be rejected. It does not require an expert in the area of management to conclude from the evidence in this case, (which consisted of government and in-house documents outlining problems at the project in plain, understandable language, and Dr. Goldberg's candid testimony at deposition, also in plain English) that, indeed, HL&P cannot escape from all blame associated with this project.

G. Discussion

Because HL&P attacked Ms. Blumenthal's credentials, and because many of the documents concerning STP were admitted into the record with little or no discussion about their contents, (to the examiner's dismay) the examiner has attempted as thorough a review of them as possible within the time allowed. The following is a discussion of problems at STP which indisputably appear in the record.

Evidence shows that data existed in 1973 indicating that the 55 month construction schedule promised by B&R (a firm with no prior experience in engineering design for nuclear plants) was optimistic then, and increasingly so as time went on. Available information

which indicated that 55 months might be unreasonable was contained in the Nuclear Regulatory Commission (NRC) "Yellow Book" NUREG-0030, which is a compilation of statistical data which profiles construction durations of nuclear plants in general and is available to all utilities. Prior to 1970, the Yellow Book showed construction durations of approximately 46 months; in 1971, 52.9 months. For the years 1972 and 1973, the months of duration skyrocket to approximately 59.9 to 70.1. Again, in 1974, the duration period for larger units is *75.9* months; in 1975, 68.6. In 1976 the duration for 1000 MW units and larger rose to *92.6* months. The year 1977 shows 67.8 months and 1978 approximately 87.7 months. Gibbs and Hill, Inc., which authored a "Performance Evaluation" of the project, dated April 1980, stated:

> In summary, there were clear indications during the period 1973 to 1978, from available information on completed projects, contemporary projects and other projects under construction that pointed to a need to reevaluate the (STP) schedule. However, there appears to have been no attempt to factor into the (STP) management and decision process this industry data, even though much was available. (Final draft, p. 44)

The evidence also shows that the magnitude by which this project was growing was not appreciated by HL&P. The Gibbs-Hill study shows that by 1976 most bulk quantities and manhours for construction had increased over *50 percent.* However, the schedule was not analyzed to determine the realism of maintaining the original fuel loading dates.

Gibbs-Hill also commented on the absence of prior nuclear project experience on this project:

> The lack of identification of cause or effect for over 4,000,000 manhours of increases on STPEGS (STP)

> can be attributed, in our opinion, primarily to the absence of prior nuclear project experience and the lack of project control systems sophisticated enough to monitor progress and successfully anticipate current and future problems on a project of such size and complexity. (Final report, p. 44)

In fact, HL&P's Dr. Goldberg stated:

> I hadn't found too many people that I would have had that confidence that they would have realized it (problems with B&R) sooner. HL&P's staff, which had that confidence that they would have realized it (problems with B&R) sooner. HL&P's staff, which of fellows with post-graduate degrees, unfortunately Cities Ex. 2, p. 60)

In summary, the most conservative statement which can be made concerning HL&P's management of this project is that the overall plant operation, (until the recent past), was definitely *not* integrated by the strong hand of an overall project manager in total control of the project.

H. Possible Regulatory Treatment of STP

HL&P refers to Ms. Blumenthal's suggestions for treatment of STP as "draconian." However, Ms. Blumenthal's suggestions might be considered very moderate in light of alternative regulatory treatment which might be recommended if mismanagement is found to exist.

For example, a penalty on return could be imposed similar to that adopted in Docket No. 3094, *General Telephone Company of the Southwest*, (June 8, 1980). Management itself could be penalized by refusing raises in officers' salary levels in cost of service. *See, e.g.* Docket No. E-2, *Application of Carolina Power and Light Company*, (September 24, 1982). In this case, CPL was also penalized by a decrease of one percent on return on equity capital because of poor management of already existing nuclear plants. However, the Commission staff conducted a *four month on-site* evaluation of project management

and intervenors also contributed substantial independent evaluation of CPL management of the plants in question.

Another regulatory alternative is an incentive/penalty program similar to that adopted by the New York Public Service Commission in Case 28059, *Inquiry, Nine Mile Point No. 2 Nuclear Station*, (April 16, 1982). In that case, the Commission adopted an incentive/penalty plan wherein targeted completion costs were set, and a twenty percent "sharing factor" between ratepayers and equity holders will be applied to any cost overrun or underrun from the target level at the time the plant is placed in service.

There are a myriad of other alternatives which come to mind which need not be mentioned here. Many regulatory jurisdictions are faced with problems at existing nuclear plants and plants under construction similar to STP. Each has its unique method of handling the situation. The point is that HL&P incorrectly suggests that any measures which go beyond doing nothing at all are excessive or uncalled for.

I. Mismanagement

The word mismanagement has been hurled about in this docket indiscriminately. This is a serious charge, and one which should be supported by substantial evidence. On the issue of whether HL&P did mismanage STP, the evidence in this case is inconclusive. The record shows that HL&P could have done a better job, but whether the company was *imprudent* and *culpably neglectful* in its role as project manager cannot be concluded from the record here.

While HL&P has been criticized for its overly optimistic outlook on the completion dates of the project, the record also indicates that most utilities and their contractors postulate future events on the basis of a "best efforts" or an "aggressive" schedule. The reason for this

philosophy is to maintain a degree of urgency and discipline on the project. It has been shown that plant deviation schedules increased from the early to late seventies. Presumably, many other utilities also found their prediction on construction durations overly optimistic.

The extent to which HL&P was aware of the problems at STP is impossible to conclude from the record. B&R's role in the problems at STP was obviously very great. In fact, B&R appears to have misled HL&P to some extent. Yet, B&R's role in the STP delays and cost overruns was not developed at all on the record, probably because of the lawsuit pending between the parties. While we know that HL&P must take some blame for delays and cost overruns, the degree of culpability is so questionable that assessment of a penalty is inappropriate. Also, the record indicates that management did take some steps over the years to "stop the bleeding." For example, an expert of Dr. Goldberg's caliber was hired in 1979 for the STP project, but left soon after for another position. Finally, the examiner has reviewed inquiries into mismanagement done by other utility commissions. This review indicated that a much more thorough investigation than that which was accomplished in this docket should precede a finding of mismanagement and the assessment of penalties.

J. HL&P-B&R Lawsuit

The question of blame for project deficiencies from the inception of the project to B&R's exit in 1981 will be resolved in the lawsuit now pending between HL&P and B&R. B&R has countersued HL&P for damages; therefore, it can be expected that a fair assessment of blame associated with the project for the years 1975-81 will eventually be decided upon in the courts.

Therefore, the examiner concludes that the issue of mismanagement of this project until 1981 is best left to the judicial system. Mr. Lee is correct that once the

lawsuit is decided, the Commission will have a better, and more comprehensive, assessment of HL&P's culpability, and it can then act accordingly. Therefore, it is recommended that the amount to be included in rate base for the years 1975-1981 be investigated in depth in the future before the plant becomes commercial.

K. A Ceiling Should be Imposed

While the record may be inconclusive as to the blame (or penalties) which should be assessed against HL&P for its role in this project until 1981, the examiner strongly suggests that the record justifies more stringent regulatory treatment of this project from this time forward.

Therefore, it is recommended that the Commission adopt Ms. Blumenthal's proposal by setting a "ceiling" in this docket for completion costs for STP of *no more* than $1.7 billion, plus accrued AFUDC, property taxes and sales taxes. The $1.7 billion is HL&P's share of the $5.9 billion estimate in Bechtel's August 1982 forecast for STP.* It is important to realize that this estimate includes over $1.1 billion for *contingencies*, and, in this regard, may be the most conservative estimate ever made for the project. However, the Cities' proposal should be modified so that if HL&P reaches this ceiling, and still needs more funding for STP, it would have three options:

(1) it may institute a docket at any time to have the ceiling amount raised;

(2) it may apply to have the ceiling amount raised in its annual rate case, or

(3) it may wait until the plant is scheduled to be included in rate base and attempt to raise the ceiling at that point.

---

* The $5.9 billion estimate is the total cost of project from its inception.

However HL&P will have the burden to show that the ceiling should be raised, i.e., that the reason for the cost overruns is *not* the result of mismanagement for which HL&P's ratepayers should not be responsible.

This suggestion is a sound one because HL&P will be given an incentive to improve its management of this project. Any further cost overruns or delays which are not attributable to any management deficiencies at HL&P (such as routine NRC scope changes, etc.) should not be excluded from the final cost of the project, provided HL&P provides proper documentation that the problem was not caused by its role as project manager. The record which the company must develop to present to this Commission in the event of any future cost overruns should cause it to pay much closer attention to problems of any nature at the project. HL&P's management capability at STP will be directly tied to its ability to include in rate base in the late 1980's all the costs it incurs in constructing STP.

Furthermore, placing the burden on HL&P to come forth with the proof on issues of cost overruns and delays means that staff and intervenors will not have to undertake what this examiner considers to be an almost impossible task at present, or six years from now, of sorting out all the problems with this project for the years 1975-1989. Another benefit of this scheme is that staff and intervenors will be able to concentrate on allegations of mismanagement for the years *1975-81* when the plant goes on line. As already mentioned, the lawsuit on this matter may have resolved the issue of blame by that time. At the very least, it will provide a great deal of information not available at this juncture.

The examiner also suggests that HL&P inform the Commission, and all interested parties, twelve months in advance of its intention to request rate base treatment for the first and second units at STP.

It is suggested, as well, that the company inform the Commission and all interested parties of any major changes contemplated in this project, at least six months in advance of any planned implementation date. For example, the Bechtel forecast showed that deferral of Unit 2 at STP for five years would cost $1.284 billion. Cancelling STP Unit 2 in September 1982 would cost $368 million.

HL&P should also be ordered to pass through to its ratepayers any amount the courts may award HL&P in its lawsuit against B&R. In this regard, HL&P should present separate schedules in its annual rate case filings showing the costs associated with this lawsuit and any recoveries.

Also, the Commission should not allow any amounts the courts may require HL&P to pay B&R to be recovered from HL&P's ratepayers either through inclusion in the cost of service or through inclusion in Account 107 as a cost of the project.

The record indicates that HL&P's ratepayers have paid approximately $111.8 million in return alone due to the inclusion of some or all of STP in CWIP over the years. This figure does not include any amounts which may have been paid prior to the time this Commission took jurisdiction over HL&P's rates. The examiner agrees with the Cities that in light of burgeoning cost to ratepayers, there should be some assurance that these units will ultimately become used and useful in providing service at the *lowest cost* possible.

HL&P continually refers to the challenge of the future faced by the company, this Commission, and presumably, its ratepayers. The examiner agrees that this challenge exists, but regards it with more trepediation than HL&P might desire. Past problems should not be ignored in favor of future promises when the risks that HL&P faces if STP meets any more failures on its course to completion loom large before us.

HL&P representatives who appeared at the hearing were very reassuring that the Bechtel forecast is a reasonable one and that STP is back on course. The Commission has the opportunity now to make sure the project stays that way.

XIII. Allen's Creek Nuclear Project (ACNP)

A. Introduction

Plans for the Allen's Creek Nuclear Generating Station (ACNP) were initiated in August, 1972, as a two unit, 2400 MW plant. According to HL&P witness D.D. Jordan, the factors of relatively low cost financing, stable and predictable load growth, and concern for fuel supply diversity led HL&P to the decision to commit to the construction of the two-unit project.

However, in September, 1975, HL&P suspended activities on this project because of the turmoil of the national economy, due to the quadrupling of imported oil prices in 1973-74. The effects of higher energy prices and a generally flattened economy had decreased HL&P's expectations of future load increases, indicating that the capacity planned from ACNP was no longer needed in those years.

During this suspension, HL&P reevaluated the project and its need for new generating capacity in the early 1980's. According to witness Jordan, the project reevaluation indicated that, even though the estimated capital costs of the project were greater than ordinarily projected, its construction and operation would still result in considerable savings to HL&P's customers. The electric demand forecast in 1976 indicated the need for new capacity by the mid-1980's, but not sufficient to warrant the construction of two 1200 MW units. Therefore, in late 1976, following the completion of the re-evaluation, HL&P announced its plans to cancel one of the units and reactivate the other for 1985 commercial operation.

Subsequently, in 1977, an application was filed with the Atomic Energy Commission to re-open the construction licensing proceedings.

Since that time, and until April 1982, those proceedings have continued. As of August 30, 1982, the hearing date in this case, HL&P had still not received a license to begin construction.

Subsequent to 1976, the company periodically updated cost comparisons of coal and nuclear units as new cost information became available. In early 1981, because of the changed circumstances relating to nuclear plant licensing and construction, and with expectations of uncertain capital markets resulting from continued high inflation and interest rates, renewed consideration was given to cancellation of the project. Mr. Jordan testified, however, that incoming President Reagan had indicated strong support for expedited nuclear licensing procedures; thus, expectations were high that a construction license would be soon forthcoming.

HL&P's optimism waned during 1981 when it became clear that the administration's statements of support and selected appointments were not sufficient to bring early improvement to the NRC's licensing procedures. As the licensing process lengthened further, it became apparent that a license would not be issued until early to mid 1982. Also in 1981, HL&P had increases in the cost estimates for the Limestone and Malakoff Lignite Projects, along with a slippage of the in-service date and an increased cost estimate for the South Texas Nuclear Project. With these increased costs, the company concluded that it could not finance its portion of the STP, ACNP, and four lignite units over the next four to five years. At this point, HL&P conducted additional studies to determine how best to allocate financial resources to meet customer needs. The benefits of the ACNP were also readdressed from an economic view. These new studies showed that those benefits to ratepayers of com-

pleting ACNP had been reduced considerably and could disappear if the then current cost and capacity factor assumptions regarding the project were not realized. A review of these studies suggested to HL&P that an independent study conducted by an outside consultant was warranted to either validate or disprove the tentative conclusions of the company's studies. Energy Management Associates (EMA) was retained to independently evaluate the project.

The conclusion of the independent evaluation was that, under current economic conditions, ACNP has minimal economic benefit when compared to available alternatives, and that the economic advantage disappears when current cost and capacity factor assumptions regarding the project were adversely altered. In such cases, the construction and operation of ACNP would be more costly for HL&P ratepayers than would construction and operation of coal and lignite alternatives.

After evaluating options available for allocating available financial resources and the associated risks—the financial risks of construction budgets, the uncertainty of cost and schedule estimates, and the operating problems inherent in possible shut-downs of nuclear plants—HL&P concluded that expenditures on ACNP should be held to a minimum pending further evaluation.

In his prefiled testimony submitted June 16, 1982, D. D. Jordan summarized HL&P's position as follows:

> Cancellation is a viable alternative if this can be done without destroying the Company's ability to move forward with a revised construction schedule that will substitute coal and lignite capacity in a timely manner. It is my hope that the Commission will work with the Company to accomplish this beneficial result for the customers of HL&P. In the interim, we shall take no action which would irrevocably foreclose or jeopardize a decision on our

application for a construction permit. (Testimony, p. 12)

As a result of its studies on ACNP, HL&P decided to accelerate the inservice dates for Limestone and Malakoff units by one year because without the acceleration of the construction of these units, and under the assumption that the in-service dates for the South Texas Nuclear Project would be delayed to 1987 and 1989, HL&P generating reserves would fall to approximately 10 percent for 1986 and 1988. If the decision was made to cancel the Allens Creek Nuclear Project, the company could allocate its financing capability to accelerate the in-service dates of the Limestone and Malakoff units and to maximize capability during the 1980's.

Mr. R. S. Letbetter testified concerning the effect of termination of ACNP without appropriate rate relief. According to him, if HL&P were to terminate ACNP without being granted rate relief to recover its investment in the project, its investment would have to be written off against income. This would result in an after-tax charge against income in excess of $200 million. Mr. Letbetter stated that these actions would prohibit HL&P from obtaining capital from the sale of mortgage bonds or preferred stock for a period of up to twelve months because the provisions of the Mortgage and Charter could not be met. This would effectively shut down HL&P's construction program and lead to significantly greater costs of the units under construction.

Mr. Letbetter also explained that there were practical limitations to the amounts of external funds which can be raised. Common stock of $200 million and preferred stock of $100 million are the maximum amounts that HL&P could expect to sell annually over the next several years. Internally generated funds and sales of debt would have to account for the remainder of the funds needed. The following chart depicts the capital requirements of

the construction program including and excluding ACNP for the period 1983-1987, the time frame most critical in terms of capital requirements.

	Construction Program incl. Allens Creek ($ millions)	Construction Program excl. Allens Creek ($ millions)
1983	$1,320	$1,136
1984	1,514	1,300
1985	1,551	1,316
1986	1,740	1,496
1987	1,593	1,471
Total	$7,718	$6,719

By removing ACNP from the construction program, approximately $1 billion of capital requirements would be eliminated. The financing plan for the construction program without ACNP still entails considerable difficulty, but, Mr. Letbetter felt, is one which may be achievable if adequate relief is granted to maintain HL&P's financial integrity.

The following table depicts the additional funds necessary to finance the construction program with ACNP versus one excluding the project. The amount of funds from internal sources is assumed to be 40 percent of the total additional requirements.

Additional Funds Necessary to Finance Construction Program Including ACNP ($ millions)

	Internal	External	Total
1983	$74	$110	$184
1984	86	128	214
1985	94	141	235
1986	98	146	244
1987	49	73	122
Total	$401	$598	$999

The funds shown to be from internal sources would have to be obtained through rate relief in excess of the rate relief that would be necessary to support a program which excludes ACNP. The $401 million shown above are after-tax dollars and represent rate increases of approximately $750 million over that five year period. HL&P estimates that additional rate relief of that same magnitude or more will be necessary to sustain the construction program excluding ACNP during the 1983-1987 time period. Thus, by continuing to build the plant, HL&P ratepayers would be faced with twice the amount of rate increases than they would with a program excluding ACNP.

Even assuming the additional rate relief were granted, an additional $600 million would have to be raised by sales of new securities. This would be in addition to the estimated $4 billion which will be obtained through sales of new securities for the construction program without ACNP. This equates to external financing of over $900 million annually for the five years 1983-1987. Realistically, there is a finite amount of securities of a given company that the capital markets will purchase each year. Mr. Letbetter felt that given the constraints on common stock and preferred stock sales, HL&P can not reasonably expect to sell additional debt securities of $598 million necessary to fund such a program. Any shortfall in external financing would have to come from the ratepayers if the program is to be accomplished. This would only compound the magnitude of rate relief required from the ratepayers.

The company's current investment in the ACNP as of March 31, 1982, is $388 million. Of this amount, $324 million is classified as construction work in progress and $64 million is classified as nuclear fuel in process. The foregoing amounts do not reflect the cost of the plant site, any additional costs that may be incurred after March 31, 1982, future costs that may be associated with termination of contracts, or any recoverable value from sales or salvage

of equipment which HL&P has already purchased or committed to purchase.

In this proceeding, HL&P is requesting approval of a proposal to recover $362 million of invested capital. This amount reflects HL&P's current investment in ACNP less an estimated $26 million for recoverable value of the uranium concentrate classified as nuclear fuel in process. For purposes of this proceeding, HL&P has not estimated any additional costs it will incur or recoverable value which may be realized. It is actively pursuing sales to third parties of equipment it has purchased or committed to purchase. Mr. Letbetter testified that there are no assurances that any equipment can be sold and any estimate of the recoverable value at this time would undermine the company's negotiating position. HL&P proposed that any additional costs which may be incurred or salvage value realized be reflected in future rate proceedings.

HL&P requests the recovery through rates of its $362 million investment in the ACNP over a 10 year period with a return on the unamortized balance of its investment in the project less the accumulated deferred income taxes related to the writeoff of the investment. The recovery of this invested capital would be accomplished by including as an operating expense both an amortization amount computed using the sum-of-the-years'-digits method for a 10 year period, and a return on the unamortized balance, calculated by applying the company's cost of capital to the average balance, net of accumulated deferred income taxes, during the period in which the rates would be in effect. The accumulated deferred taxes would be reduced at the same rate the investment in the project is amortized.

HL&P requested a 10 year recovery period because this is the approximate additional period of time during which the ACNP would have been included in the construction program. The sum-of-the-years'-digits method is being requested to determine the annual amount of the company's investment to be recovered, because, according to Mr. Let-

better, this method will most closely assign the recovery of costs to the periods which will benefit the most from a cancellation of the project. The risk associated with nuclear construction is greatest during the early stages of construction. As the project moves closer to completion, the construction risks diminish and the positive attributes of less expensive fuel costs of nuclear plants begin to be anticipated. The earlier construction periods are most vulnerable to regulatory change, schedule slippages and cost overruns.

The sum-of-the-years'-digits method assigns greater recovery of costs to the early periods and gradually reduces the recovery amount over the ten year recovery period. HL&P argues that this method more appropriately matches the assignment of costs to the periods which will be benefitted the most by the reduction of the capital requirements and the risks associated with nuclear construction. In particular, it will provide for the recovery of $263 million or 73 percent of the company's investment in the project during the 1983-1987 period.

The Company is also requesting a return on its unrecovered investment because HL&P contends that ACNP was a prudent project, one undertaken to fulfill its obligation to provide its customers reliable electric service at the lowest practical cost. Therefore, HL&P argues that its investors should not be penalized by denying a return on such an investment.

HL&P contended that a denial of a return would not provide for a sharing of costs between the ratepayer and shareholder because such a denial would ultimately penalize both groups. Ratepayers would not benefit from the deteriorated financial position which would result.

B. Is Allen's Creek a Cancelled Project?

At the time of the filing of this rate case, HL&P *strongly recommended* cancelling ACNP, and cautioned

that appropriate action by the Commission which would provide for recovery of the investment in ACNP was necessary. On the morning of August 26, 1982, at a settlement prehearing conference, HL&P made a public announcement indicating that it had decided to cancel ACNP. During the course of the hearing HL&P also made an announcement that a withdrawal of its application for licensing had been filed at the NRC and that proceedings at NRC on ACNP had been terminated.

The Cities of Houston and Baytown and a majority of the member cities of the Coalition treated ACNP as a deferred debit rather than CWIP or an extraordinary loss. In effect, their treatment of ACNP was to exclude the plant from this case altogether. The Cities claim ACNP was not officially cancelled at the time of the rate hearings at the city level and argue that ACNP is not an officially cancelled plant to this day. According to them, until such cancellation takes place, ACNP cannot be considered in this rate case.

C. Discussion

The Cities filed numerous motions and pleadings with regard to this issue.

However, Cities' objections to treatment of ACNP in this docket can be resolved by answering two questions:

(1) What is required of a public utility and this Commission when a project such as ACNP is cancelled?

(2) Is it proper to consider the issue of ACNP in the city appeals consolidated in this docket?

The Cities characterize HL&P's cancellation of ACNP as a "unilateral abandonment" and take the position that HL&P must formally apply for "decertification" of ACNP before any other action may be taken. It is argued that HL&P must acquire a certificate that "neither the present nor future convenience and necessity

will be adversely affected by cancellation of ACNP," (Section 58(b) of the Act) to allow any ratemaking treatment to be accorded to ACNP.

This means that ACNP can be considered cancelled only after a formal application is made for decertification, notice is given, a hearing conducted, and a final order approving cancellation is rendered. The Cities further contend that any decision the Commission might render with regard to ACNP in this docket without first having followed these decertification procedures would be advisory only and outside the authority of the Commission to render.

The Cities find support for their arguments in Section 58(b) and 62(a) and 3(s) of the Act.

The pertinent sections of these portions of the Act read as follows:

> Sec. 58. (a) The holder of any certificate of public convenience and necessity shall serve every consumer within its certified area and shall render continuous and adequate service within the area or areas.
>
> (b) Unless the Commission issues a certificate that neither the present or future convenience and necessity will be adversely affected, the holder of a certificate shall not discontinue, reduce, or impair service to a certified service area or part thereof except for:
>
> (1) nonpayment of charges;
>
> (2) nonuse; or
>
> (3) other similar reasons in the usual course of business.
>
> (c) Any discontinuance, reduction, or impairment of service, whether with or without approval of the Commission, shall be in conformity with and sub-

ject to such conditions, restrictions, and limitations as the Commission shall prescribe.

Sec. 62. (a) The Commission at any time after notice and hearing may revoke or amend any certificate of convenience and necessity if it finds that the certificate holder has never provided or is no longer providing service in the area, or part of the area, covered by the certificate.

Sec. 3. (s) "Service" is used in this Act in its broadest and most inclusive sense, and includes any and all acts done, rendered, or performed and any and all things furnished or supplied, and any and all facilities used, furnished, or supplied by public utilities in the performance of their duties under this Act to their patrons, employees, other public utilities, and the public, as well as the interchange of facilities between two or more of them. Service shall not include the printing, distributions, or sale of advertising in telephone directories.

In support of its contention on these issues, Cities' argue that Sections 3(s) of the Act provides that the word "service" used in 58(b) and 62(a) of the Act is to be construed in its *broadest* sense to include the word facilities, and that discontinuance, reduction or impairment of service as used in Section 58(b) must be construed to mean any diminution or dilution in size, amount or extent of service.

HL&P and staff argue that certificates of convenience and necessity relate only to retail utility service *areas* and that requirements to certificate *facilities* or items of plant are found only in P.U.C. SUB. R. 052.02.05.056.

Staff also argued that Section 39 of the Act requires the Commission to set rates that recover all reasonable operating expenses and provide a reasonable return on invested capital. According to staff, the Act places no limitations of certification, or lack thereof, on this exer-

cise of ratemaking powers. For example, although a plant may be certificated, the Commission can exclude from rates any costs incurred in the construction or operation of the plant if it finds that those expenditures were imprudent or unreasonable. Conversely, the Commission could allow a company to recover costs attributable to a plant which has not yet been certificated upon a finding that the costs were reasonable and benefitted the public interest, e.g., preconstruction planning studies and design work which must be completed before a certificate application can be filed. Indeed, there are no restraints in the Act on what the Commission can find to be reasonable costs to be recovered through rates other than excessive return (Section 40(a) of the Act), affiliate transactions, and income taxes (Sections 41(c)(1) and (2) of the Act).

As to Cities' argument that the Commission will render an advisory opinion in this case if it gives ratemaking treatment to ACNP without first decertificating the facility, and without the NRC allowing withdrawal, staff argues that once the Commission makes a simple *factfinding* that ACNP has been prudently cancelled, and makes its decision on appropriate ratemaking treatment, the order is complete and final. The opinion will not be advisory because it will clearly set forth costs to be recovered. The recovery will not be contingent upon any other act of the company or the Commission, and this Order would be appealable.

Cities also urge that there is no substantial evidence in this case to show that the plant has actually been cancelled because without decertification by this Commission and "allowance" by the NRC of withdrawal of HL&P's application, no reasonable person can conclude that ACNP has been cancelled. Cities further argue that any action taken in this docket with regard to ACNP would be arbitrary, capricious and an abuse of this Commission's discretion. Finally, Cities argue that the requested amortization of

ACNP amounts to an out-of-period adjustment for an unknown change, because any known and measurable change with respect to this plant could occur only after a decertification hearing before this Commission, withdrawal of the construction permit application before the NRC, and formal cancellation of the project.

The major points of dispute in this case had to do with the Cities' position on these legal issues. This position was ardently defended throughout the hearings. The Cities have put their eggs in one basket on this issue, resting their refusal to render any ratemaking treatment to ACNP on their legal conclusion that the plant has *not* been cancelled.

HL&P must bear the brunt of the blame for this dispute. The company walked a fine line on ACNP from the time this case was filed. Only when it was clear that its balancing act was working to its disadvantage did HL&P formally move to cancel ACNP, *four* days before hearing. There can be no argument that in the testimony as prefiled, representatives at the highest level of HL&P management were at their equivocal best, merely "recommending" cancellation. It is true that the schedules in the rate filing package itself present ACNP as a cancelled plant. However, a strong recommendation to regulatory authorities in prepared testimony that a plant be cancelled is inappropriate when economic studies show that the plant *should* be cancelled. D. D. Jordan, Chief Operating Officer at HL&P, did not want to formally cancel this plant because of advice from lawyers that the NRC proceedings should not be abandoned for fear that the Texas Commission might order HL&P to continue to construct ACNP. Also, the company wanted some "assurance" of the regulatory treatment it could expect if ACNP were cancelled. *No* party to this docket has argued that this Commission has the authority to involve itself in utility management to the extent of ordering HL&P to either abandon or to continue to construct ACNP. True, this objective could be accomplished

indirectly through ratemaking treatment; however, HL&P has the right to appeal direct or indirect interference with its management decisions, and would likely prevail if the evidence showed cancellation of ACNP to be a reasonable decision. Moreover, it was improper for this utility to approach its regulators in the context of a rate case (whether the regulators be the Cities, staff or this Commission), to "test the waters" on what sort of monetary treatment its management decision would receive before that decision was made.

As to the issue of whether ACNP must be formally processed for decertification before appropriate ratemaking treatment can be afforded, the Cities position cannot be adopted.

This is an issue of first impression before the Commission. As can be gleaned from the rather convoluted arguments on the issue, there is no statutory provision or Rule which specifically addresses the situation facing us here.

Section 58(b) of the Act does state that service in a certified service area cannot be reduced or impaired without a finding by this Commission that the public interest will not be harmed. Section 3(s) of the Act states that the term "service" is a word used in its broadest sense and includes any and all acts done, rendered, or performed, and any and all things furnished and supplied, and any and all facilities *used, furnished,* or *supplied* in the performance of a public utility's duties. The crux of this issue is whether a project in the present state of completion as ACNP can be described as a "service" within the meaning of § 3(s) and 58(b) of the Act. At the present time ACNP is a project still in its infancy. Land has been set aside, preliminary engineering and legal work has been accomplished, and some plant equipment has been acquired and stored away for safekeeping. According to Section 3(s), the facilities included in the broad term "service" are to be "used, furnished or supplied . . . in the performance of duties." ACNP cannot be described as in use, or furnishing

anything to HL&P's service area under the present state of facts. If the Cities' argument is taken to its logical conclusion, just about every activity HL&P undertakes to render service to its certificated area would be included in the term "service." Under this strained reading, HL&P would have to apply to this Commission whenever it intended to abandon or discontinue service from any facility, for example, an old substation, or an unused transmission line. Indeed, it follows from the Cities reading that any time HL&P intended to discontinue "any act done, or performed in its service to the public," a formal proceeding would be necessary. The Cities' position is untenable and based on a reading of Section 3(s) which goes beyond the plain meaning of that section. Simple common sense compels the conclusion that a facility must be *contributing* in some manner to the "service" a utility provides before the issue of *public harm* addressed in § 58(b) even arises.

Furthermore, the Cities' position on this issue must be rejected because staff's argument that this Commission is free to give ratemaking treatment to ACNP, regardless of certification, or lack thereof, is entirely correct. The significance of this portion of the Cities' argument should not be underestimated. Acceptance of the theory that this Commission's ratemaking authority is limited by restraints such as whether or not a piece of plant has been certificated, or decertificated, would change the entire complexion of ratemaking before this Commission. The reasonable conclusion to be drawn from the Cities' argument is that the ratemaking treatment of each item included in a utility's total invested capital would depend on formal certification or decertification, if that plant in any way related to the broad term "service." This is not an accepted theory now, and Section 39 of the Act, which authorizes the Commission to compensate a utility with a reasonable return on its "investment" certainly does not contemplate that this return is contingent upon such procedural niceties.

The examiner cannot agree with the Cities that the Commission will be issuing an advisory or contingent

Order in this case because cancellation is still at issue. It is hard to envision what more HL&P could do to cancel this plant. Formal cancellation was announced, (although belatedly), and the NRC has terminated its licensing proceedings. The examiner has analyzed the materials presented by HL&P on the issue of whether it is prudent to cancel this projec and finds the evidence that the plant should be cancelled so convincing that no further discussion of the matter is warranted. In later sections the ratemaking treatment recommended for ACNP will be discussed. Therefore, the Commission can find in this case that ACNP was cancelled, that it was prudent to cancel it, and that it can be accorded ratemaking treatment in this case. As staff noted this decision is certainly final and appealable.

Finally, as to Cities' contention that there is no substantial evidence in this case of cancellation, there is such evidence in this case, *ad nauseum*. Also, the argument that this type of adjustment is post-test year and not known and measurable until cancellation is found to be a fact is an argument of accounting principle which should not be strictly applied to an issue of such significance as ACNP.

D. Can Allen's Creek be Considered in the Rate Appeals Consolidated in this Case?

The answer to this question is yes. HL&P deserves faint praise for the manner in which it presented its case at the municipal level, and its last minute cancellation of the project only exacerbated an already difficult situation.

However, there is no doubt in this examiner's mind that the Cities had ample opportunity to consider the issue at their level, and decided to take the position that ACNP had not been cancelled in a legal and factual sense, and therefore, it would receive no ratemaking treatment. The Cities received substantial information on ACNP through the discovery process, and "consid-

ered" ACNP to the extent that they chose to ignore it. Between the time of appeal and time of hearing ACNP was cancelled, at least in a factual sense; nevertheless, Cities continue to refuse to acknowledge that any cancellation has occurred.

The fact is that from the information presented in the rate filing package, the Cities could have concluded that ACNP was cancelled for ratemaking purposes and given it the ratemaking treatment the Cities deemed proper. However, the Cities chose not to, relying on a misguided belief that a decertification hearing must be held. Moreover, the fact that the Cities chose not to develop facts on ACNP which were capable of being fully tried during the Cities' respective hearings does not prevent the Commission from considering all relevant evidence on those same facts in the *de novo* appeals. Furthermore, the Cities' rate ordinances are not binding upon this Commission, in a *de novo* appellate review. The record shows that the evidence of intent to cancel ACNP was before the Cities in their rate determinations. ACNP was, in fact, effectively cancelled at the time of the City hearings. The Cities deliberately chose to ignore the issue of the cancellation as a technical strategy, and not from lack of information.

It is fundamental that an appeal can involve only that which was litgiated below. ACNP was litigated below in that no treatment was accorded to the plant. This litigation involving ACNP was appealed by HL&P to the Commission. That the set of facts regarding that issue changed from the time of appeal to the time of hearing is of no consequence. ACNP should be included for all purposes in the Cities' appeals consolidated in this case.

E. What recovery is proper for ACNP?

HL&P seeks ten years' amortization according to the sum of years' digits method, and return on the unamortized balance. Staff prefers ten years straight amortiza-

tion on a somewhat lower balance, with return to be earned only on the debt and preferred portion of the unamortized balance. CCRR would exclude all amounts expended after 1976, or in the alternative 1979. DOE and TNP would not allow a return on the unamortized balance.

F. Prudency of Decisions Associated with Allen's Creek

1. Committee for Consumer Rate Relief

CCRR witness Robert Smith-Johannsen testified concerning the prudency of HL&P's decision to pursue construction of ACNP in 1976. CCRR's position is that, based on the circumstances and information in 1976, the decision to reactivate the project was imprudent. According to CCRR, prudence should be determined by an inquiry into reasonableness and rationality of management's judgments under the circumstances existing at the time. Mr. Smith-Johannsen also claimed that the decision to continue ACNP from 1976 to 1979 became even more questionable based on escalating capital costs, regulatory burdens and other matters which will be discussed below.

CCRR alleges that HL&P's decision to continue ACNP was imprudent because HL&P ignored, or failed to consider, relevant and crucial data readily available to it in formulating its decision to reactivate ACNP. Specifically, CCRR claims that the nuclear plant capacity factor, (defined as the actual electrical output as a percentage of nominal design output), used in the company's 1976 cost comparison study, upon which HL&P based its decision to reactivate ACNP, was unrealistically high. HL&P used an 80 percent capacity factor.

CCRR witness Smith-Johannsen testified that capacity factor, as a measure of plant performance, is central in determining the fixed charge component of generating costs. A plant's capital costs and non-variable O&M costs must be applied to actual plant electrical output. An

actual output is related to the design rating through the capacity factor. The lower the capacity factor, the greater the fixed charges per kwh. The economics of nuclear plants, with high capital costs, is particularly sensitive to the estimate of capacity factor. To take advantage of lower nuclear fuel costs, a high capacity factor is important.

More specifically, Mr. Smith-Johannsen explained that since fixed costs account for about 80 percent of generating costs for nuclear plants, as opposed to 40 to 45 percent for coal plants, plant reliability is of greater importance to nuclear economics. For each successive ten percentage point drop in capacity factor below 80 percent, total nuclear generating costs increase by 11 percent, 13 percent and 16 percent. For coal plants, the cost increases are only about half of the above values.

According to HL&P witness Guy, who prepared all of the forecast studies on ACNP, (with the exception of the EMA study, previously referred to), the 80 percent factor used in his 1976 study, (which study concluded that ACNP should be reactivated), was obtained from Mr. George Oprea, his supervisor. Mr. Oprea apparently received this number from his staff; Mr. Oprea's staff allegedly based the factor on authoritative sources. However, CCRR showed that in 1976, NRC information indicated that the Boiling Water Reactor (BWR) units then in existence (the BWR would be used at ACNP) had operated at only a 56 percent capacity factor through year-end 1976.

Mr. Smith-Johannsen testified that if historical data had been used in estimating a capacity factor in the 1976 re-evaluation, the cost in mills per kilowatt hour between nuclear and coal would have been comparable. However, CCRR also indicated that HL&P had also understated its fixed cost factor for nuclear plants in its 1976 re-evaluation. Mr. Johannsen added a "nuclear fixed cost factor" of one percent to his study to account for: (1) a

nuclear risk premium, necessary to attract investment capital for nuclear plants; (2) interim capital replacement—to make necessary design changes on backfits; (3) shorter plant life span due to radioactive wear or inability to meet new safety standards; and (4) shorter tax life. Another 1.5 mills/kwh was added to account for insurance costs, which CCRR alleged HL&P had not included in its study. Costs of 2.1 mills/kwh were included for decommissioning costs at the plant. In addition, Mr. Smith-Johannsen felt that HL&P had underestimated its O&M expenses for nuclear power by at least 2.5 mills/kwh. He also found that HL&P's estimate of nuclear fuel cost unfairly favored nuclear by at least 4.0 mills/kwh.

Overall, CCRR found that HL&P had *underestimated* nuclear generating costs in its 1976 study by 22.5 mills/kwh. Obviously, if this underestimation were corrected for in Dr. Guy's studies, HL&P would probably have not reactivated ACNP and would have proceeded with the coal option.

Mr. Smith-Johannsen pointed out that the coal alternative became even more attractive from 1976 to 1979 because capital costs for nuclear power plants continued to escalate more rapidly than those for coal. Interest rates rose, and safety regulations promulgated by the NRC increased substantially over this period, especially after the accident at Three Mile Island. He also felt that HL&P should have taken into account other industry data which indicated ACNP cost projections were unrealistically low, (*e.g.* Ebasco and General Electric letters and reports to HL&P), as well as HL&P's difficulties with STP, discussed in detail in another section of this Report.

2. Staff

Staff's position is that if it is found that ACNP has been formally cancelled, some ratemaking treatment should be allowed. Staff suggested a ten year straight-

line amortization period; staff would allow return only for long term debt and preferred stock obligations associated with the unamortized balance. Staff witness Neff considered this treatment a "sharing" of the costs of cancellation between ratepayers and stockholders.

After the hearing on the merits, staff proposed in its brief that, at a minimum, all post-January 18, 1982, expenditures for ACNP be excluded from any authorized recovery. In support of its position, staff argued that it was improper for HL&P not to formally cancel ACNP when (1) feasibility studies in the late fall of 1981 showed that ACNP was no longer an economically feasible project, and, (2) HL&P was having difficulties at STP and with getting an NRC construction permit for ACNP.

According to staff, the results of the EMA study were made known to senior management in late December 1981, or early January, 1982. At that time, this Commission was told that for all intents and purposes ACNP was cancelled except for formally withdrawing the NRC permit application. Staff insists that there can be no doubt that from January 18, 1982 forward, ACNP should have been cancelled, and that *any* expenditures incurred from that time forward should be excluded from amortization. Staff alleged that HL&P management had unreasonably delayed formally announcing cancellation of the project until just four days before the hearings began in this case.

3. DOE AND TNP

DOE and TNP would disallow any return on the unamortized balance. DOE argues that to allow return on the unamortized balance is tantamount to including the investment for ACNP in rate base.

TNP's position is that it would be against Commission precedent to allow a return on the unamortized portion of ACNP. In HL&P's previous rate cases, the Commis-

sion did not allow a return on the unamortized balances of ACNP No. 2 and the Freestone project costs. Language in those cases expressed the notion that where a plant would never be "used and useful," it would be improper to allow the utility to earn a return on the unamortized balance. The Commission likewise ruled in Docket No. 2606, *Application of Texas Electric Service Company*, (October 16, 1979), that earning a return on the unamortized balance of cost of service items not used and useful would not be allowed.

TNP also suggested that since approximately 40 percent of the construction budget of HL&P is provided by monies collected through rates, to allow a return to HL&P on those amounts which have been furnished by the ratepayers would be inequitable. The question is, TNP asserts, whether the ratepayers, who initially provided the funds, should now be forced to additionally pay a return to the common equity holders for those sums.

G. Discussion and Conclusion

Mr. Smith-Johannsen's discussion on ACNP brings into focus the major problems which have beset HL&P in the recent past. The examiner agrees with CCRR that if proper studies had been accomplished based on historical industry data, ACNP would not have been reactivated.* While it is true that Dr. Guy also used an overly optimistic 80 percent capacity factor for coal in his studies, it is important to realize that since capital costs account for about 80 percent of generating costs for nuclear plants, and only 40 to 45 percent for coal plants, a reduced capacity factor for nuclear plants is

* HL&P claims that Mr. Smith-Johannsen relied on the studies done by an expert, Mr. Charles Komanoff, and that these studies have been attacked by experts in the nuclear industry. For this reason, the examiner has relied on information provided by CCRR which is contained in industry data, and not in Komanoff's analysis.

approximately twice as influential in increasing generating costs as the same reduction for coal.

Also, while a different fixed cost factor may not be necessary for nuclear plants, it is difficult to understand why HL&P did not include costs in its studies such as insurance expense and interim capital replacement, which are costs which are obviously higher for nuclear plants than for coal.

Also, operating experience through 1976 indicated that HL&P did overstate O&M costs for nuclear plants to some degree. While one might quibble with Mr. Smith-Johannsen over the actual underestimation of nuclear costs by HL&P associated with ACNP, all of the factors he mentioned, taken together, indicate that HL&P ignored historical data available at the time these studies were done and ignored some of the more obvious risks associated with nuclear plants in its studies. The result: the studies were skewed in favor of the ACNP option.

However, these studies are not the only evidence of HL&P's imprudency associated with ACNP. When one takes into account the fact that from 1976 to 1979 capital costs for nuclear plants continued to escalate more rapidly than those for coal, the safety regulations promulgated by the NRC increased substantially as a result of the Three Mile Island incident, and ACNP became stalled at the NRC in 1979 because of intervention at the construction permit hearing, the delay in cancellation can be characterized as clearly imprudent.* Finally, HL&P's difficulties with STP should have been factored into its studies on ACNP.

Staff witness Lee, who has followed this project over the years, also testified on ACNP. He indicated he was

---

* Massive interventions occurred in 1979 at the NRC. The examiner agrees with HL&P that it need not have cancelled HL&P solely because of this. However, a serious evaluation of whether the project would ever get off the ground was called for in 1979 before another $166 million was poured into the project.

not surprised that ACNP had been cancelled and had in the past doubted whether the project would ever be a reality when HL&P began having problems at the NRC.

The examiner will not second-guess HL&P on its reactivation of ACNP in 1976, but agrees with CCRR that, based on all the circumstances mentioned above, the plant should have been cancelled sometime during late 1979-early 1980. Therefore, expenses incurred from approximately January 1, 1980 to August 26, 1982, of approximately $166 million,** should be removed from the total amount to be amortized of $361.1 million. The $361.1 million is staff's total to be amortized after a minor adjustment to HL&P's total of $362 million. Thus, a total of approximately $195 million should be amortized on a straight-line basis over ten years. The ten year straight-line method more fairly assesses the burden of this plant on HL&P ratepayers. HL&P's method is based on a method of accelerated depreciation which has been consistently rejected by this Commission. Furthermore, it is designed to produce cash flows to achieve financial integrity measures which the examiner believes to be beyond those needed to maintain HL&P's bond rating.

If the removal of this large an amount is unacceptable to the Commission, the examiner recommends that at the very least the company be penalized for not formally cancelling ACNP by at least January 18, 1982; the record shows that senior management had every intention of cancelling ACNP from that date on. The examiner has already referred to the inappropriateness of company management "strongly recommending" in this rate case that ACNP be cancelled. This "recommendation" in HL&P's direct case indicates a peculiar paranoia on behalf of management that its major decisions may be severely criticized in regulatory forums and that, therefore, it should seek the advice and comfort of these au-

---

** These figures can be derived from HL&P Ex. Nos. 15, 18, 19.

thorities before acting. This not an indication of vigorous management, and is both imprudent and improper. Removal of costs incurred from January 18, 1982 to August 26, 1982 would exclude a total of $27.3 million from the amount to be amortized.

D. D. Jordan, Chief Executive Officer of HL&P, testified that because HL&P had no intention to continue ACNP, expenditures were reduced to a minimum at ACNP after January, 1982. He also testified that he instructed his staff to reduce expenditures to the "minimum level that we could . . . and continue to have the (NRC) construction permit issued viable." These actions —to ask for amortization of ACNP in a rate case, (or an additional $90 million burden on ratepayers on an annual basis), while not formally cancelling the plant, *and* while continuing to pursue licensing of ACNP at the NRC— were also improper and imprudent. Mr. Jordan's explanation—that the company did not want to "burn its bridges" on ACNP, or lose any headway it had gained at the NRC from 1976 to the present, was not persuasive. Surely, this Commission and HL&P ratepayers would be shocked to learn in the future that a "cancelled" plant they had been paying for over the years had been suddenly "reactivated" because HL&P had continued to seek NRC licensing of that plant even after rate relief for cancellation of the plant had been afforded at an earlier time. However, the record indicates that this is what HL&P had in mind until the Cities and staff put a stop to it by refusing to allow amortization of a plant which, in their opinion, had not been cancelled.

The examiner is aware that the test year in this docket ended March 31, 1982, and that the recommended exclusion of expenses at ACNP extends to August 26, 1982, the actual date of cancellation. The examiner believes that the ratepayers should not compensate HL&P for poor management performance in this instance, and that the most logical approach to relieving ratepayers of this

burden is to exclude expenses associated with the period during which HL&P has been found to be at fault. The examiner finds that this period extends from January 1, 1980, to August 26, 1982. The examiner is also aware that some expenses during this time frame could not be avoided whether the plant was cancelled in January, 1980, or not. This Report has already detailed the evidence that HL&P should have cancelled ACNP in 1979-1980, the improper posture in which this case was filed, management's indecision on cancellation until only four days before hearing, the difficulties associated with this last minute change of position, and the illogical and unpersuasive reasons given for this delay. These factors taken together clearly justify the exclusion of costs from January 1, 1980 to August 26, 1982, of some $166 million from staff's total figure to be amortized over ten years. Ratepayers should not be burdened with expenditures which were imprudently incurred because of management's deliberate attempt to avoid the facts concerning ACNP for over two years.

It is also recommended that the Commission disallow a return on the unamortized balance. In determining this result, the questions raised by CCRR concerning management's reactivation and the unreasonable delay in cancellation, should be considered. Furthermore, the Commission has refused to allow a return on unamortized balances in previous rate cases. Moreover, ACNP will never be a "used and useful" element of rate base, and to include any portion of the plant in rate base for return purposes would violate traditional accounting principles. The argument that equityholders should not be denied "carrying costs" on the unamortized portion of this plant over the period of amortization should be rejected because since the inception of ACNP in 1972, the carrying costs associated with this project have been provided by ratepayers through either inclusion of CWIP in rate base for financial integrity, or through capitalization of AFUDC on the construction not allowed in rate

base. To now require that ratepayers compensate common stockholders for the carrying costs associated with ACNP, (which amounts to $25,000,000 in this rate case) is unfair and inequitable.

The examiner recommends against adoption of HL&P's suggestion that if a full return is not authorized, accumulated deferred taxes should be deducted as "cost free" capital only to the extent that it exceeds the invested capital not earning a return. The amount of deferred taxes will not be recorded on the company's books until year end 1982, and HL&P's recommendation is inconsistent with the examiner's recommended treatment of deferred taxes associated with Allen's Creek Unit No. 2 and Freestone, discussed earlier.

Finally, HL&P should be ordered to credit its ACNP plant balance with any amounts received from sales of equipment or costs avoided through negotiation of termination of outstanding contracts. These amounts should be included annually in HL&P's ratefilings. The question of allocation of these amounts to customer classes should be litigated in future rate cases.

XIV. Cost Allocation

A. Methodology

During settlement negotiations prior to hearing in Docket 4540, a stipulation on the cost allocation methodology most appropriate for HL&P in this case was agreed upon and signed by HL&P, the staff, and most of the intervenors. Neither the Coalition of Cities or any individual city entered into the stipulation. CCRR also did not sign the stipulation. The stipulation was therefore presented for consideration as a limited evidentiary stipulation of material fact. All signatory parties reserved the right to present testimony and to cross-examine other witnesses concerning other methodologies.

As to allocation methodology this stipulation provided that:

1. The probability of negative margin (PONM) or probability peak methodology originally proposed by HL&P for the allocation of production plant was not appropriate for HL&P in this case;

2. The Average and Excess with 4CP (A&E w/4CP) methodology proposed by the staff for allocating production plant was the most appropriate methodology for HL&P in this case.

HL&P then withdrew its prefiled testimony concerning its proposed allocation methodology. The Cities relied on the company's proposed methodology to develop their proposed rate structure; however, they presented no direct case on the appropriateness of that methodology.

Cities' desire that allocation be accomplished by the PONM method, and argued that there is sufficient evidence in the record to support the use of the PONM allocation methodology. The only expert testimony presented on the PONM method which might lend support to that method was staff witness Saathoff's statement that he was familiar with the PONM methodology and familiar with the considerations taken into account by that method, as well as the actual procedure for calculations thereunder. In addition, he testified that the theory behind the method is valid and that the choice of a cost allocation methodology is a matter of considerable judgment, there being no method without drawbacks. He also testified that there is a substantial degree of flexibility in the selection of an appropriate methodology. In any proceeding there is no single correct method by which to allocate production plant.

At the hearing both Texas-New Mexico Power Company's witness, Shuman, and staff witness, Saathoff, also testified on cross-examination that the production plant allocation for the residential class under the PONM

method is in the range of 32 to 33 percent, whereas the allocator which falls out from the staff's proposed methodology is 37.864 percent; that assigned by the average and excess/4 non-coincident peak (A&E w/4NCP) methodology proposed by the Texas-New Mexico Power Company is 33.5969 percent. Therefore, the greatest impact on the residential class from this portion of the allocation process is caused by the staff's methodology which was stipulated to by a majority of the parties. Cities contend, therefore, that it is reasonable for the Commission to review the relative merits of the alternative cost allocation methods proposed in this docket.

Those parties which stipulated to staff's method contend that there is no evidence whatsoever in the record of this case on which to base an opinion on the appropriateness of the PONM method. The intervenors entered into the record their prefiled testimony advocating certain other cost allocation methodologies, but each of them agreed through the stipulation that the methodology proposed by the staff was the most appropriate for HL&P for this case and as such should be adopted by the Commission.

The Cities support PONM because it has less dollar impact on the residential classes. While the examiner does not doubt that the PONM method may allocate fewer dollars to the class the Cities represent, it is not possible to recommend the PONM method, because it is not supported as a reasonable method by any evidence in this docket. Moreover, A&E w/4CP, the method stipulated to by the parties, is supported by expert testimony, and is preferable to PONM in several other respects.

The Cities adopted HL&P's allocation methodology because it suited their needs. However, for whatever reasons, they did not support the PONM method at hearing through expert testimony of their own. Furthermore, HL&P put the Cities on notice early in the hearings process that the testimony and schedules concerning PONM

would *not* be offered. The testimony and schedules were deleted *without* objection. The Cities did present evidence through cross-examination of several witnesses that PONM has less dollar impact on residential customers than A&E w/4CP or A&E w/4NCP; however, this evidence is meaningless without testimony from a credible expert stating that the PONM cost allocation is suitable for HL&P at this time.

The record evidence relating to allocation, other than that presented by the Cities, was that of intervenors, all of which attacked the PONM method, and staff's testimony, which supports the A&E w/4CP method. Staff preferred this method because it recognizes that HL&P must build and plan generating units to meet customer demand and energy requirements in the most economical way possible. It is therefore appropriate to recognize both factors in allocating such plant. Also, Mr. Saathoff felt that since the summer months' system peak demands are of major concern to HL&P in building and operating generating units, it is appropriate to give weight to customer demand during those periods. The A&E w/4CP method recognizes both the customer's year round energy requirements and summer months demand requirements.

The examiner is mindful of the difficulties which beset the Cities on the issue of allocation. While HL&P did abandon the Cities when it stipulated to staff's methodology, the Cities chose not to support the PONM method through their own witnesses and all testimony and schedules on PONM were deleted from the record without objection.

The record evidence in this case supports the stipulated method. Allocation methodologies should not be recommended for adoption simply because one method appears to impact one class less than another. There must be some theoretical basis to show that this impact is justifiable, or that the method, as a whole, is reasonable.

Finally, the examiner believes that the A&E w/4CP method is appropriate for HL&P in its present circumstances, because it takes into account the summer peaking characteristics of HL&P as well as a customer's year round energy requirements.

B. TNP Miscellaneous

TNP objected to allocation of general advertising, miscellaneous and general expenses, and prepaid gross receipts taxes to the public utility class, and argued that the public utility class should be allocated only its proportionate share for rate case expenses.

TNP feels that since costs are allocated on the basis of cost causation, it is improper to allocate these costs to TNP because TNP did not cause the costs to be incurred.

TNP's proposal should not be adopted because the company is suggesting that HL&P should trace all costs and attribute these costs in a precise manner. If this is to be done for TNP, it should rightfully be done for each customer class. There are probably costs incurred by HL&P associated with its service to TNP for which the industrial or commercial class might feel no responsibility. The theory behind an overall allocation methodology such as A&E w/4CP is that it allocates costs as much as is equitably possible, on a customer class basis. To go back after the allocation study has been run to subtract from and add to the totals, as TNP proposes, overly complicates the process. No witness testified that the allocation process is exact; each customer class must bear some inaccuracies inherent in the method finally adopted by the Commission.

XV. Rate Design

A. Residential Rate Design

The Cities proposed a 3-tiered rate design for the residential class. This rate structure is identical to that adopted by ordinance by a majority of the coalition member cities in this docket.

The rate design adopted by the Cities for the residential class is an inverted block rate with an $8.00 minimum charge and a thirty kilowatt hour usage minimum. The Cities availed themselves of the computer facilities of HL&P in the development of this residential rate structure. In doing so, certain parameters were set by the Cities. They are as follows:

(1) Rates are to recover the money allocated to the class from the Cities' base rate revenue increase; and

(2) The increase to the class is to be spread over all three of the tiers.

The rate design which results from the application of these parameters to the Cities' allowed based rate revenue increase is as follows:

Total Usage Brackets	Rate for All Kwh
0-30 kwh	$8.00 min. charge
31-750 kwh	2.1015¢ per kwh
751-1500 kwh	3.1015¢ per kwh
1501 and over kwh	4.1015¢ per kwh

This compares to HL&P's proposal, as follows:

0-30 kwh	$8.00 min. charge
kwh charge	May-October 4.846¢ per kwh 3.090¢ for bill of 750 kwh or less
kwh charge	November-April 3.090¢ per kwh

The percentages of residential customers who fall into each Total Usage Bracket during the Summer Months and during the Winter Months are as follows:

	Summer	Winter
0-750 Kwh	29%	59%
751-1500 Kwh:	31%	28%
over 1500 Kwh:	40%	13%

Various calculations were made, on the record, comparing the effect of the Cities' rate design with the current rates and the rates proposed by HL&P under their two-tiered summer/winter differential rate design. The net result of all of these comparisons is that under the rate design adopted by the Cities, the summer electric utility bills of 60 percent of the residential consumers will be lower than those they would receive under HL&P's proposed rate, and the winter bills of 87 percent of the residential class consumers will be lower under the same comparison.

HL&P proposed to continue to use a summer/winter differential rate with a summer economy step for residential usage of 750 kwh or less per month. This design, which has been approved by the Commission in past HL&P rate proceedings, assigns more cost to seasonal on-peak residential usage than to winter use, while allowing a lower summer rate for customers who can limit their usage to 750 kwh or less per month. Thus, HL&P contends, electric customers receive proper price signals to be conservation-minded during the on-peak period.

HL&P objected to the Cities' method because it was entered in the record without the support of any expert opinion, and proposed a 3-tier inverted block residential rate with no summer/winter differential. According to HL&P witness Schaeffer, such a rate design would in fact lower certain consumers' summer base rates, *even* after taking into effect the Cities' proposed $181 million rate increase for HL&P. Mr. Schaeffer also testified

that such a proposal would send incorrect price signals to residential consumers by pricing electrical usage during winter months at the same rate as summer usage. Thus, HL&P concluded, the Cities' proposed rate design has the dual distinction of providing improper price signals to consumers during both the summer and winter months, and should therefore be rejected.

The majority of the parties also objected strenuously to the Cities' proposal, not only for reasons related to its merit, but because the 3-tier structure was entered into the record through an adverse witness, HL&P witness Schaeffer, who made it abundantly clear on the record that while he had assisted the Cities' staff at their request in the computer runs used to develop the rate design, he could in no way justify, support, or propose such a rate design. His reasons were that such a design was not cost based, that it was based on an arbitrary shuffling of prices, that it did not necessarily represent a price break for the poor, and that it would not result in significant conservation benefits to the reserve margins of the company.

Indeed, staff argued that the 3-tier rate design was fabricated wholly from thin air and that it was an orphan with no expert "parent" to sponsor it on the record.

After review of the record on this issue, the examiner must recommend against the Cities' proposal. Beyond the fact that no expert in rate design testified to the reasonableness of the method, (in fact, just the opposite occurred), this rate design does not reflect true costs to serve customers in the winter and summer because it sends false price signals to customers by actually lowering the bills of customers in the middle tier during the summer and raising bills in the winter. This is not justified when taking into account that the summer system peak represents costs to HL&P of approximately 13¢/kwh in the on-peak period; winter costs amount to

only 1.4¢/kwh. As has been mentioned previously in this Report (several times over), HL&P is faced with some seriously low reserve margins if it does not contain growth in peak load within the next several years. And this is not to say that the company can stop the growth, only that it must halt the large increases in peak which occurred over the past few years. Thus, a method which would convey false price signals to a large group of residential customers during summer peak months should not be favored. In fact, as already mentioned, the record indicates that a 1,000 kwh per month customer would actually receive a rate reduction from *present* rates during the summer months.

The record shows that, while the Cities' rate design proposals were sincere, there was no attempt to base their rates on costs to serve. In fact, as the testimony of Mr. Schaeffer shows, the Cities simply picked several differentials between the tiers at random in an effort to meet their parameters mentioned earlier. The record also shows that a customer using 2,000 kwh during the winter would experience a 70% increase from existing rates under the Cities' proposal. This makes no sense because the costs imposed on HL&P during winter months in no way justify such a cost increase.

The Cities had in mind a price break for those users whose usage patterns fall into middle tier and argued that their rate design may represent a price break for the poor. TNP and HL&P pointed out that it is not necessarily so. In fact, low-income customers often have drafty, poorly insulated houses and have to rely on energy inefficient window units in the summer and resistance heating in the winter. These customers may well end up in the *highest* tier under the Cities' rate design. In point of fact, the examiner believes that the Cities' rate design is an attempt to lower summer rates for middle-class customers. There is nothing offensive about this, but the examiner doubts that this 3-tier proposal will really have much impact on the poor.

Finally, the Cities advocate their rate design as a means of encouraging conservation. HL&P countered that their summer/winter differential and time of day rates will accomplish the same end and are cost based as well. The only testimony that the Cities presented on the record that their rate design will promote conservation was that of Ms. Kathryn Whitmire, the mayor of Houston. Two experts also commented on the possible effects of a 3-tier rate design. Both Messrs. Saathoff and Schaeffer felt conservation could be effected only by giving consumers correct economic price signals. It has not been shown that the Cities' 3-tier rate design will enhance conservation. In fact, if winter heating bills are increased as a result of the Cities' rate design, any conservation is likely to occur in the off-peak period for the utility instead of during the critical summer peak.

In summary, the rate design proposed by the Cities has no credible support in the record, was established according to arbitrary standards, and is non-reflective of the true cost to serve. The method will not accomplish the goals it was meant to promote, and should be rejected in favor of HL&P's methodology, which is consistent with approved rate design for HL&P in past cases before this Commission.

B. TNP Ratchet

Under HL&P's proposal in its rate tariffs, the demand ratchet for the Public Utility Class would be maintained at its current level of 85% The TNP proposal as recommended by witness Krause would lower the demand ratchet to 75% from its present level.

HL&P argued that a demand ratchet, even at the 100% level, offers no windfall to a utility. It merely provides assurance that those demand-related costs properly assigned to a customer are, in fact, paid by that customer; such costs being just as real regardless of whether or not the customer is wholesale or retail. Ac-

cording to HL&P, to the extent that a demand ratchet of less than 100% is used, the risk of nonrecovery of demand related costs incurred by a utility in serving a large customer increases.

HL&P also argued that the implementation of a ratchet at least as large as 85% is especially appropriate to TNP because of its status as a public utility. If TNP were to supply all of its customers' power needs through its own generation capacity, it would incur 100% of the demand costs necessary to meet its customers' electricity needs on an ongoing basis and would design its rates accordingly. However, where the revenues allocated to TNP as a customer class in an HL&P rate proceeding are not in fact realized by HL&P during the time period that such rates are in effect, HL&P must bear that revenue loss to the extent that the demand ratchet is less than 100%. HL&P contended that to increase the current exposure of risk to HL&P by lowering the ratchet to 75% is simply unfair.

TNP argued that studies conducted by TNP personnel indicate that HL&P would experience no revenue loss as a result of the lower ratchet. Also, TNP pointed out that it is not proposing that its total revenues decrease in any way, only that the time frame for collecting these revenues be changed.

The examiner believes that the real concern here should be whether there is a purpose served by a demand ratchet, and if there is a purpose, to what extent a ratchet should be applied. The record in this case is replete with evidence that HL&P has set ambitious goals to limit its load growth in the near future. Therefore, reason exists to ratchet a customer such as TNP to attempt to control load. TNP does argue that because a large portion of its system is residential and commercial, usage on its system is weather sensitive, so that ratchet provisions really are of no effect. This is unpersuasive because

TNP can and does design its own rates to take into account this ratchet provision, and therefore, the ratchet does serve its purpose. The examiner also believes that the 85 percent level should be maintained to assist HL&P in controlling load growth to the greatest extent possible.

C. Fuel Clause

HL&P suggested that non-fuel costs associated with the new purchased power contracts the company enters into after this rate order be passed automatically through its fuel adjustment clause. This would preclude Commission review of the reasonableness of the rates paid under these contracts for some period of time. Therefore, the proposal should be rejected.

HL&P proposed that its fuel clause be amended to recover costs incurred for the handling and storage of its spot market purchases of natural gas and other fuels. These costs have been excluded in the past from the fuel clause. TNP was the only party to comment on the change and recommended that the clause be changed so that recovery of the handling and storage costs will take place, not when incurred, but only when the fuel handled and stored was actually burned in the production of power. Apparently, this is what HL&P intended, and the clause should be changed to indicate that this is the case.

D. Dow Rate

Dow's participation in this case was aimed at encouraging this Commission to do the following:

1) Order HL&P to design a firm rate schedule for Dow whereby Dow's base revenue is at least no more than the LOS-B class base revenue.

2) Order HL&P to design an interruptible rate schedule which incorporates a term not longer than one year, which is not tied to a firm take, and which is not take-

or-pay except for a minimum charge to cover actual costs and return.

1. Firm Rate

Dow feels that discrimination exists, in violation of Section 38(a) and 45 of the Act, in relation to the Dow and LOS-B rate classes.

Dow submits that the evidence in this hearing is unrefuted that intra-class discrimination exists as to Dow's present and proposed firm rates and that such discrimination was and is unreasonable and undue. According to Dow this evidence is:

a. Dow is the lowest cost-to-serve industrial customer.

b. Dow competes directly with other industrial customers in the system in the production of specific chemicals.

c. These other customers are in the LOS-B class.

d. Present and proposed comparable electric service to Dow is $2,659,420/year and $2,810,410/year higher, respectively, than to an LOS-B customer, notwithstanding a higher cost to serve the latter.

In support of its argument that it is the lowest cost-to-serve customer, Dow points out that Diamond Shamrock, one of the largest industrial customers on the system, operates two large plants in the Houston area which manufacture chlorine, caustic soda and related products. These plants purchase electricity from HL&P via the LOS-B tariff. The cost of electricity is a major consideration in the cost of producing these products. These two plants manufacture products which compete directly with Dow's products. Examples are chlorine, caustic soda, organic solvents and ethylene dichloride. Diamond and Dow are both high load factor customers. Dow argues that while Diamond attempts to operate at 100% load factor, Dow's firm is always 100% take-or-pay and

always operates at a 100% load factor. The LOS-B class has a ratchet which Dow does not have. This means, for example, that an LOS-B customer can sit at 91% of capacity and pay only for 91% of the contract KVA capacity, but also can increase its requirements to 100% and pay only for that whenever he uses it. Dow cannot do this. In effect, if an LOS-B customer contracted for 225 MW as does Dow, the 90% ratchet would require HL&P to have a 225 MW available even when that LOS-B customer takes up to 10% less. Dow also contends that while that customer does not have to pay for that 10%, Dow does not have that luxury.

Dow also pointed out that it is the only customer that takes a 345 KV and transforms it down to 138 KV and operates its own system at 138 KV. Notwithstanding this lower cost to transmit to Dow, Dow pays the average transmission cost in that Dow is assigned a portion of the 69, 138, and 345 KV transmission costs. Dow also argued that there is no characteristic of service to any LOS-B customer that would result in a lower cost to serve as compared to the firm service to Dow. Therefore, Dow is upset that under the company's proposed rates, the cost to Dow for this firm service is $2,810,410/year more than an LOS-B customer would pay for the same load.

HL&P argues that Dow is unique and should be treated thusly; at the very least Dow cannot justify the same treatment as an LOS-B customer. For example, Dow can effectively increase its MW consumption up to 20% above its interruptible contract amount during off-peak hours and incur no additional demand charge, thus allowing a rate significantly below the secondary KVA rate available to LOS customers ($1.75/KVA) under Sheet No. D-5 and D-6 of the present and proposed tariffs. Dow is also the only customer that has the demand component of its bill always rounded down to the next lower increment of 5,000 KW, provided that a cer-

tain minimum demand is met during that month. HL&P also points out that as the only 100% load factor customer on the HL&P system, Dow offers absolutely no diversity to the system and that this makes Dow more costly to serve than any other industrial customer. Indeed, HL&P contended that if Dow were included in the LOS-B class of customers, one might expect strenuous objection from that class since the diversity now present in that class would deteriorate and thus increase the demand related costs assigned to that class. HL&P also pointed out that Dow is served from the most expensive transmission lines on which HL&P serves major industrial loads.

The record in this case indicates that Dow is probably neither the most costly nor the least costly customer on the HL&P system. The evidence also indicates that Dow and the LOS-B class are not so similarly situated that they deserve equal relative rates of return, or, in the alternative, base revenues which are equal. Indeed, Dow and the LOS-B class have offsetting characteristics which both add and detract to their costs to serve and it is very difficult to place a value, in terms of relative rate of return, on the differences in costs imposed on HL&P by the two classes. Dow has continually seen its relative rate of return in each case before this Commission move toward unity. Mr. Saathoff's methodology in this case moves Dow toward unity less gradually that LOS-B, (i.e., Dow moves from 1.2446 at current rates to 1.1710 under proposed rates; LOS-B moves from 1.0954 to 1.0826).

Because it is not possible to evaluate the difference or similarities between Dow and LOS-B so as to justify an equal relative rate of return or equal base rate revenue requirement for the two classes, and because any difference in return between these two classes has been diminishing in each rate case, Dow's proposal on this issue must be rejected.

2. Interruptible service.

According to Dow, the company's interruptible offerings have turned out to be abject failures. Dow has terminated its 275 megawatt interruptible contract, leaving only a 10 megawatt customer taking interruptible who has also given notice of termination.

Dow pointed out that Dr. Guy testified that load management will have a significant impact on HL&P's load, and that he talked about peak shaving, commercial selective load control, voltage reduction, and commercial air conditioning load control along with residential demand limiters as load management techniques the company was undertaking. However, Dow is correct that the record shows that planned load management will do nothing to stem the growth of the system peak demand in any significant manner until 1986. At that time, there will be a saving of 800 megawatts or 2.8%. But at that time, hopefully, some of the planned construction will be onstream which will actually lessen the need for planned load management. Dow asserts that planned load management is needed now, but the short-sighted rate policies of the company preclude utilization of their best load management technique—the sale of interruptible power.

Dow argued that none of the interruptible rates is reasonable or cost based.

Interruptible service to Dow can be interrupted instantaneously without notice at any time. Further, Dow generation picks up load to support the HL&P system when there is a system problem. The instantaneous megawatt reduction in delivery to Dow in these cases is greater than all the interruptible megawatts which HL&P has been able to sell to all other customers to date. Dow thus argues that the 100% take-or-pay requirement in its tariff is unreasonable in light of the zero requirement for firm generating capacity. Dow also feels the three-year notice to terminate is unreasonable.

Dow also pointed out that Milton Lee testified that if no new interruptible loads come on the scene, this could have a drastic effect on HL&P's ability to continue to provide reliable and adequate service to its ratepayers.

Dow also disliked the D-19 rate and charged that it is counter-productive to load management since the service is unavailable without first purchasing a firm service, and compared to Dow interruptible, it is not truly interruptible in that the rate schedule provides a minimum of ten minutes notice before the service may be curtailed whereas Dow's interruptible is instantaneous.

Dow alleged that the proposed D-19 rate is discriminatory in that it allows a 12-month notice to terminate firm service by converting to interruptible whereas Dow interruptibility in the D-19 rate is 300 hours compared to the 760 hours allowed to Dow.

HL&P and Dow seem unable in this instance to agree on even the most basic concepts underlying interruptible service to Dow or other customers.

However, conclusions can be drawn from the record without deciding each contested factual issue raised by Dow and HL&P.

There is overwhelming evidence in this case that HL&P is badly in need of any load control techniques for the near future. Interruptible rates are proven load management techniques and HL&P has lost a valuable interruptible customer in Dow. Obviously, HL&P's proposed interruptible tariff is not worthwhile to Dow. This situation calls for some persuasive action by the Commission. The provisions requested by Dow, (that a tariff be designed incorporating a term not longer than one year, which is not tied to a firm take, and which is not take-or-pay, except for a minimum charge to cover actual costs and return) do not seem unreasonable or extraordinary taking into account the need for interruptible load. Therefore, a tariff should be designed with these provisions incorporated therein and offered by HL&P in a separate docket within ninety (90) days fol-

lowing the final order in this case. The reasonableness of the proposed tariff should be fully litigated. Very general parameters for the tariff have been recommended here. The specific tariff provisions should be the subject of a full hearing. In the meantime, the interruptible tariff sheets proposed herein should be approved.

E. kVA vs. kW

DOE contended that HL&P's use of kVA rather than kW demand billing determinants is inappropriate in that HL&P, unlike most utilities, has continued an antiquated practice of using kVA rather than kW in billing the demand component of its tariff under the following rate classes: MGS, LGS, LOS-A, LOS-B, TNP Contract.

DOE contended that HL&P's demand rate methodology is not cost based and is unjustly discriminatory and should be eliminated, that HL&P demand rates should have a separate kW demand and kVAR demand charge, and that the record supports use of $0.15 per kVAR charge for all HL&P rates with a demand billing component. After determination of the kVAR related revenues for each class, the remaining demand related class revenue requirements can be recovered through application of an appropriate kW demand charge for each class.

DOE's proposal should be rejected because HL&P's use of kVA billing determinants takes into account the kVAR component of customer load because kVA is equal to the square root of the sum of kW^2 and $kVAR^2$. Mr. Lundberg's proposal will also impose an administrative burden on HL&P in calculating customer bills. Furthermore, the examiner is reluctant to endorse a proposal which affects five classes of customers, when the proposal appears to benefit only one member of the class advocating the change.

F. Stipulated Rate Design Issues

1. Greater Houston Hospital Council (GHHC)

This Partial Stipulation was uncontested during the hearing and provides for the inclusion of an experimental

rate for operation of customer-owned standby generation equipment.

2. LOS-A—LOS-B

This Partial Stipulation was also uncontested during the hearing and would require HL&P to file with the Commission on or before February 1, 1983, draft revised tariffs for the LOS-A and LOS-B customer classes. Said tariffs, to be filed for demonstration purposes only, would be designed to permit the returns of both LOS classes to be set at system average without inducing the migration of customers between classes and thus resulting in a potential loss of revenue to HL&P. Also, the parties to the Stipulation agreed that any revenue increase awarded in Docket No. 4540 and allocated to the LOS-A and LOS-B classes should be included in the demand component of each such rate schedule, provided that the load factor cross-over point between the two classes should not exceed eighty-one percent (81%).

Both of these stipulations were agreed to by most of the parties who participated in the hearings, and appear reasonable; therefore, adoption is recommended by the examiner.

XVI. Indemnification

The Cities noted that HL&P limited the scope of its liability under certain circumstances by an expanded indemnification clause in their proposed tariff in the Rate Filing Package. Cities contended that no testimony in support of the clause was presented by HL&P to either the City Councils or the Commission. As a matter of policy, the Cities did not allow the change in the clause from the previous year and urged the Commission to not adopt the changes.

HL&P's witness Doan did describe the change in the indemnification clause in his prefiled testimony and stated that HL&P has proposed its indemnity clause pursuant to the settlement in HL&P's last rate case, Docket No. 3320 (September 1980). HL&P's clause is similar

to the specifically approved in Docket No. 3198, *Application of Central Power and Light Company* (June 22, 1981). HL&P has restricted application of its indemnity language to only those narrow instances involving (1) customer-owned lines or equipment, and (2) the energization of HL&P lines by customers with the capability to do so. Because the HL&P clause is similar to that approved in Docket No. 3198, and because there is no reason that HL&P and its ratepayers should be responsible for injury or damage arising on the customer's side of the point of delivery, nor for injury or damage resulting from a customer energizing HL&P's lines without advance notice, the clause, as modified, should be approved.

XVII. Surcharge

In each of the city appeals, HL&P has requested that all expenses associated with these appeals be collected by a one-time surcharge to bills to customers within each city according to the expenses incurred by that city. This suggestion is unacceptable and should not be adopted. This is in keeping with the recent ruling in Docket No. 4240, *Application of Texas New Mexico Power Company*, (June 2, 1982). *See also*, Docket No. 3716, *Application of Southwestern Electric Power Company*, (June 18, 1982).

XVIII. Refunds

On October 20, 1982, HL&P implemented interim rates and rates under bond pursuant to § 43(d) of the Act which would generate revenues of $181 (sic) annually over present rates. In the event the Commission adopts a revenue requirement lower than the $181 million interim increase, or adopts an allocation method different from that recommended by the examiner, refunds will be necessary. Therefore, it is recommended that HL&P follow the general procedures set forth below:

(1) Refunds should be made to each customer whose rates under the interim tariff exceed those rates under the tariff approved in this case.

(2) All customers should be notified by HL&P of their possible entitlement to refunds and the manner in which refunds will be made in the first billing practicable after the issuance of this order.

(3) All refunds should be made with 12.63 percent annual interest. (Staff's overall weighted cost of capital).

(4) HL&P shall make refunds in the form of a one-time credit to customer's bills.

(5) For customers who are due a refund but have left the HL&P system, or who leave the system prior to receiving full credit on future bills, a cash payment should be made for the amount of refund which they have not received credit for.

(6) Within six months of the date of this order, HL&P should file with the Commission Secretary a report detailing, among other things, the amount of money collected in excess of the approved tariffs, the amount of money refunded under this order, and the approximate number of customers for whom refunds have not been made due to inability to locate them, along with the amount of money owed to this latter group of customers.

XIX. Summary and Recommendation

Based on all of the above, the examiner finds that HL&P has a base rate revenue deficiency $200.3 million. This amount is approximately $136 million less than the base rate revenue deficiency claimed by HL&P of $336 million, approximately $19 million more than that recommended by the Cities, and some $51 million lower than staff's recommendation at the time of hearing.

XX. Findings of Fact and Conclusion of Law

A. Findings of Fact

1. On June 16, 1982, Houston Lighting and Power Company (HL&P) filed an application requesting authority to change rates in all areas within Texas to which it pro-

vides utility service, and over which the Commission has original jurisdiction. The proposed increase would generate additional revenues of $336 million annually.

2. Appeals from all but approximately eight of the cities served by HL&P were consolidated into this docket.

3. HL&P is an electric utility which provides retail and wholesale electric service to customers within several counties in the Texas Gulf Coast region.

4. The depreciation rates proposed by HL&P are reasonable and result in an annual depreciation expense of $133,634,000.

5. The net current cost of HL&P's plant is $6,015,220,000.

6. HL&P's invested capital is valued at $3,954,357,000, as shown below:

	(In Thousands of Dollars)
Plant in Service	$3,962,797
Accumulated Depreciation	797,665
Net Plant	$3,165,132
Construction Work In Progress	947,699
Property Held For Future Use	3,180
Nuclear Fuel	60,769
Working Cash Allowance	44,540
Materials and Supplies	42,257
Prepayments	3,267
Fuel Inventory	76,706
Less	
Deferred Taxes	330,228
Pre1971 Investment Tax Credits	8,279
Customers Deposits	20,695
Property Insurance Reserve	8,120
Other Cost Free Capital	21,865
Total Invested Capital	$3,954,363

7. The rate base adjustments recommended by the examiner and used in deriving Finding of Fact No. 6 are reasonable for the reasons stated in this Report.

8. Inclusion of 100 percent of HL&P's CWIP and NFIP in HL&P's invested capital is necessary to insure the company's financial integrity for the reasons described in this Report.

9. A balance of 34.625 percent net current cost and 65.375 percent net original cost is reasonable for the purpose of calculating the adjusted value of HL&P's invested capital. Using these percentages, the adjusted value of HL&P's invested capital is $4,941,200,000.

10. For the purpose of computing a fair return for HL&P, the following capital costs and capital structure are appropriate.

	Amount	Percentage	Cost	Cost Weighted
Long-Term Debt	$1,903,042	45.06%	9.19%	4.14%
Preferred Stock	243,518	5.77%	8.23%	.48%
Common Equity	1,795,597	42.51%	16.85%	7.17%
Accumulated Deferred Investment Tax Credits	281,393	6.6%	12.63%	.84%
Total	$4,223,550	100.00%		12.63%

11. For reasons set out in this Report, 16.85 percent return on common equity capital is reasonable for HL&P. An annual return of $499,435,000, which constitutes a 12.63 percent return on HL&P's invested capital, and a 10.11 percent return on the adjusted value of HL&P's invested capital, is fair and reasonable, is adequate under efficient management to allow HL&P to maintain its current credit rating and to attract the capital necessary for the proper discharge of its duties as a public utility, and is sufficient to insure confidence in the financial integrity of the company.

12. HL&P's adjusted test period cost of service is as described on Exhibit I, attached to this Report.

13. The cost of service adjustments recommended by the examiner and used in deriving Finding of Fact No. 12 are reasonable for the reasons set out in this Report.

14. The 17 percent return factor for UFI is excessive and should be lowered according to the examiner's recommendation. HL&P should file quarterly for Commission approval of affiliated fuel costs.

15. HL&P's service is adequate at present; however, service could deteriorate in the future. HL&P should be put on notice that its service to existing and new customers may be limited if it experiences abnormal outages.

16. Although there were allegations of mismanagement at South Texas Nuclear Project, (STP), the record was inconclusive on the matter.

17. The record does indicate that a ceiling should be imposed on costs to be incurred by HL&P at STP from this time forward, and that other protective measures having to do with the court suit should be adopted.

18. HL&P should give notice of inclusion of STP in rate base within twelve (12) months of the filing of its rate case, and six months notice of any expected change of plans for STP.

19. The evidence shows that HL&P was prudent in its decision to cancel Allen's Creek Nuclear Project (ACNP).

20. ACNP has been formally cancelled.

21. HL&P acted imprudently in its management decisions associated with ACNP in that HL&P did not cancel the plant on or about January 1, 1980, HL&P underestimated the cost of ACNP in its studies and these underestimations were further exacerated by events occuring in 1979-1980 which should have caused cancellation of the plant.

22. This imprudence was substantial enough that a penalty should be assessed.

23. It is logical to exclude all costs for the project from January 1, 1980, the date the project should have been cancelled, until August 26, 1982, the date it was can-

celled, or a total of $166 million. Thus, a total of $195 million should be amortized over a ten year period on a straight-line basis.

24. HL&P's test period revenue deficiency is found to be $200.3 million, rather than $336 million as stated by the company in its rate-filing schedules.

25. The cost of service allocation method stipulated by the parties and described as the Average and Excess-4 Coincident Peak Method (A&E w/4CP) is found to be applicable in this case.

26. The revenue requirement by class is to be established in accordance with relative rates of return which have been determined to be reasonable in that they generally move each class toward an equal rate of return for all classes.

27. The record does not support a change in TNP's ratchet, nor does it support TNP's theory that certain costs should not be allocated to TNP.

28. HL&P's proposal that new purchased power contract costs be automatically included in the fuel adjustment clause should be rejected as unreasonable. HL&P's fuel clause should be changed to reflect the fact that recovery of the handling and storage costs will take place when the fuel is burned.

29. Dow's rate is reasonable and not discriminatory because the record does not reflect that Dow costs less to serve than the LOS-B class, and because Dow has consistently moved toward a unity return in each rate case before the Commission.

30. HL&P needs an interruptible rate which will allow Dow's participation.

31. DOE's proposal that a kVAR charge be imposed on all HL&P rates with a demand billing component should not be accepted.

32. HL&P's indemnification clause is reasonable and should be adopted.

33. The Cities should not be surcharged for expenses associated with their appeal cases before this Commission.

B. Conclusions of Law

1. The Commission has jurisdiction over this rate change application pursuant to Sections 43 and 26 of the Public Utility Regulatory Act, Tex. Rev. Civ. Stat. Ann. art. 1446c (1980). The rates set herein will be applicable only to those customers in the unincorporated areas and those customers residing in the Cities from which appeals have been taken and which have been consolidated with this Docket. (See Exhibit VII, attached).

2. HL&P has the burden of proof to establish its revenue deficiency under its present rates and to establish the amount of such deficiency that will be collected under its proposed rates pursuant to Section 40(b) of the Public Utility Regulatory Act.

3. HL&P proved that it is entitled to additional annual revenues to $200.3 million.

4. The present rates for service in the areas served by HL&P over which this Commission has jurisdiction are insufficient to provide HL&P with the revenues approved in this Order and should be adjusted to conform to the rates established herein for each class of ratepayers.

5. The rates prescribed herein will allow HL&P to recover its operating expenses together with a reasonable return on its invested capital, pursuant to provisions of Section 39 of the Public Utility Regulatory Act.

6. The rates prescribed herein will yield no more than a fair return upon the adjusted value of the invested capital used and useful by HL&P in rendering service to the public, as provided by Section 40(a) of the Public Utility Regulatory Act.

7. The rate of return granted herein is sufficient to assure confidence in the financial soundness of HL&P and is adequate, *under efficient and economical management*, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties; is comparable to those returns of other similar companies having comparable risk; and is sufficient to assure confidence in the financial integrity of HL&P so as to maintain its credit and to attract capital. (*Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 88 L. Ed. 333; and *Bluefield Water Works and Improvement Co. v. Public Commission of West Virginia*, 262 U.S. 679, 67 L. Ed. 1176.)

8. The Commission need not make a finding in this proceeding, or in a separate licensing proceeding, that cancellation of ACNP will not adversely affect the present or future convenience and necessity, because ACNP is not rendering a "service" within the meaning of 3(s) of the Act which is being discontinued, reduced or impaired within the meaning of Section 58(b) of the Act.

9. It is proper to consider the issue of the ACNP cancellation in the city appeal cases consolidated in this docket because the issue of cancellation of ACNP was fully litigated at the municipal level and appealed *de novo* to this Commission.

10. The rate design guidelines as set out in the relative rates of return are just, reasonable and not unreasonably discriminatory.

11. The Commission is authorized to require HL&P to refund to affected customers any overcollections resulting from the implementation of interim rates or bonded rates on October 20, 1982, and has authority to determine the

manner in which such refunds shall be made, Sections 43(d) and 43(e) of the Act.

Respectfully submitted,

/s/ Angela Demerle Williams
ANGELA DEMERLE WILLIAMS
Hearings Examiner

APPROVED on this the 9th day of November, 1982.

/s/ Rhonda Colbert Ryan
RHONDA COLBERT RYAN
Acting Director of Hearings

APPENDIX F

Order of the Public Utility Commission of Texas Denying Rehearing

---

PUBLIC UTILITY COMMISSION
OF TEXAS

Docket No. 4540

APPLICATION OF HOUSTON LIGHTING AND POWER COMPANY FOR A RATE INCREASE

ORDER

On December 6, 1982, this Commission entered its Final Order in the above-styled docket.

The following Pleadings of note have been filed since December 6, 1982:

Document	Source	Date Filed
1) Motion for Rehearing	General Counsel, P.U.C.	12/13/82
2) Motion for Rehearing	Committee for Consumer Rate Relief	12/14/82
3) Motion for Rehearing	City of Houston	12/15/82
4) Motion for Rehearing	Dow Chemical Company	12/20/82
5) Motion for Rehearing	Houston Lighting & Power Company (HL&P)	12/21/82
6) Motion to Take Judicial Notice of Court Papers	HL&P	12/21/82
7) Motion to Take Judicial Notice of Certain Material Filed with Commission	HL&P	12/21/82

Document	Service	Date Filed
8) Answers to Motions of HL&P	General Counsel	12/27/82
9) Motion to Supplement Record	HL&P	12/29/82
10) Motion in Opposition to HL&P's Request for Judicial Notice, etc.	City of Houston	12/29/82
11) Reply to HL&P's Motion for Rehearing	Texas Industrial Energy Consumers	12/29/82
12) Answer to Motion for Rehearing of HL&P and Motion to Strike Exhibits from HL&P's Motion for Rehearing	General Counsel	12/29/82

After full consideration of all of the Motions, Answers and Replies, the Commission issues the following Order:

I. All Motions for Rehearing are DENIED.

II. Houston Lighting and Power's Motions to Take Judicial Notice of (1) Court Papers and (2) Certain Material filed with the Commission, are DENIED.

III. HL&P's Motion to Supplement the Record is DENIED, with the understanding that the memorandum from Marilyn Neff, accountant, to the Commission, dated December 21, 1982, is already part of the record in these proceedings.

IV. Staff's Motion to Strike Six Exhibits from HL&P's Motion for Rehearing is GRANTED.

RENDERED at Austin, Texas, on this 31st day of December, 1982.

PUBLIC UTILITY COMMISSION
OF TEXAS

/s/ H. Moak Rollins
H. MOAK ROLLINS

/s/ George M. Cowden
GEORGE M. COWDEN

/s/ T. G. Smith
T. G. SMITH

ATTEST:

/s/ Rhonda Colbert Ryan
RHONDA COLBERT RYAN
Acting Secretary of the Commission

APPENDIX G

Notice of Appeal

IN THE SUPREME COURT OF TEXAS

No. C-5705

PUBLIC UTILITY COMMISSION OF TEXAS,
Petitioner/Appellee

v.

HOUSTON LIGHTING & POWER COMPANY,
Respondent/Appellant

NOTICE OF APPEAL TO THE
UNITED STATES SUPREME COURT BY
HOUSTON LIGHTING & POWER COMPANY

TO THE SUPREME COURT OF TEXAS:

Respondent/Appellant Houston Lighting & Power (HL&P) hereby appeals to the United States Supreme Court from the judgment of the Texas Supreme Court in Cause No. C-5705 issued December 16, 1987, (Rehearing denied May 4, 1988), affirming in part the order of the Public Utility Commission of Texas (PUC) issued December 6, 1982, in Docket No. 4540.

HL&P gives notice that it appeals from the entire judgment of the Texas Supreme Court on the ground that the Court upheld the validity of a Texas statute, as that term has been interpreted under 28 U.S.C. § 1257 (2) and its predecessors, under a challenge that the actions of the PUC are repugnant to the Constitution and

laws of the United States. HL&P's notice of appeal is taken pursuant to 28 U.S.C. § 1257(2).

Respectfully submitted,

HUGH RICE KELLY
Senior Vice President and
General Counsel
Houston Lighting & Power Co.
P.O. Box 1700
Houston, Texas 77001

ROBERT J. HEARON, JR.
Graves, Dougherty, Hearon
& Moody
2300 First RepublicBank Tower
Austin, Texas 78701
(512/480-5600)

By /s/ Robert J. Hearon, Jr.
ROBERT J. HEARON, JR.
SBN 09346000

Attorneys for Respondent,
Houston Lighting &
Power Company

CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing "Notice of Appeal to the United States Supreme Court by Houston Lighting & Power Company" has been forwarded to all counsel of record by placing a copy of same in the U. S. Postal Service or by hand delivery on this the 21st day of July, 1988.

/s/ Robert J. Hearon, Jr.
ROBERT J. HEARON, JR.

APPENDIX H

Excerpts from the Texas Public Utility Regulatory Act As in Effect Before September 1, 1983

Art. 1446c. Public Utility Regulatory Act

ARTICLE I. SHORT TITLE, LEGISLATIVE POLICY, AND DEFINITIONS

Legislative policy and purpose

Sec. 2. This Act is enacted to protect the public interest inherent in the rates and services of public utilities. The legislature finds that public utilities are by definition monopolies in the areas they serve; that therefore the normal forces of competition which operate to regulate prices in a free enterprise society do not operate; and that therefore utility rates, operations and services are regulated by public agencies, with the objective that such regulation shall operate as a substitute for such competition. The purpose of this Act is to establish a comprehensive regulatory system which is adequate to the task of regulating public utilities as defined by this Act, to assure rates, operations, and services which are just and reasonable to the consumers and to the utilities.

* * * *

ARTICLE VI. PROCEEDINGS BEFORE THE REGULATORY AUTHORITY

Power to insure compliance; rate regulation

Sec. 37. Subject to the provisions of this Act, the commission or railroad commission is hereby vested with all authority and power of the State of Texas to insure compliance with the obligations of public utilities in this Act. For this purpose the regulatory authority is empowered to fix and regulate rates of public utilities, including

rules and regulations for determining the classification of customers and services and for determining the applicability of rates. No rule or order of the regulatory authority shall be in conflict with the rulings of any federal regulatory body.

Just and reasonable rates

Sec. 38. It shall be the duty of the regulatory authority to insure that every rate made, demanded, or received by any public utility, or by any two or more public utilities jointly, shall be just and reasonable. Rates shall not be unreasonably preferential, prejudicial, or discriminatory, but shall be sufficient, equitable, and consistent in application to each class of consumers. For ratemaking purposes, the commission or railroad commission may treat two or more municipalities served by a public utility as a single class wherever the commission or railroad commission deems such treatment to be appropriate. Rates charged by a gas utility to an industrial customer for supplying gas under a contract and other similar large volume contract customers are just and reasonable and shall be approved by the regulatory authority if the regulatory authority finds that:

(1) neither the gas utility nor the industrial customer had an unfair advantage during the contract negotiations; or

(2) the rates in the contract are substantially the same as rates contained in contracts between the gas utility and two or more other industrial customers contracting under the same or similar conditions of service; or

(3) competition exists either with another gas utility, another supplier of natural gas, or with a supplier of an alternative form of energy.

Fixing overall revenues

Sec. 39. In fixing the rates of a public utility the regulatory authority shall fix its overall revenues at a level

which will permit such utility to recover its operating expenses together with a reasonable return on its invested capital.

Fair return; burden of proof

Sec. 40. (a) The regulatory authority shall not prescribe any rate which will yield more than a fair return upon the adjusted value of the invested capital used and useful in rendering service to the public.

(b) In any proceeding involving any proposed change of rates, the burden of proof to show that the proposed change, if proposed by the utility, or that the existing rate, if it is proposed to reduce the rate, is just and reasonable shall be on the public utility.

Components of adjusted value of invested capital and net income

Sec. 41. The components of adjusted value of invested capital and net income shall be determined according to the following rules:

(a) Adjusted Value of Invested Capital. Utility rates shall be based upon the adjusted value of property used by and useful to the public utility in providing service including where necessary to the financial integrity of the utility construction work in progress at cost as recorded on the books of the utility. The adjusted value of such property shall be a reasonable balance between original cost less depreciation and current cost less an adjustment for both present age and condition. The regulatory authority shall have the discretion to determine a reasonable balance that reflects not less than 60% nor more than 75% original cost, that is, the actual money cost, or the actual money value of any consideration paid other than money, of the property at the time it shall have been dedicated to public use, whether by the utility which is the present owner or by a predecessor, less depreciation, and not less than 25% nor more than 40%

current cost less an adjustment for both present age and condition. The regulatory authority may consider inflation, deflation, quality of service being provided, the growth rate of the service area, and the need for the public utility to attract new capital in determining a reasonable balance.

(b) Separations and Allocations. Costs of facilities, revenues, expenses, taxes, and reserves shall be separated or allocated as prescribed by the regulatory authority.

(c) Net Income. By "net income" is meant the total revenues of the public utility less all reasonable and necessary expenses as determined by the regulatory authority. The regulatory authority shall determine expenses and revenues in a manner consistent with the following:

(1) Transactions with Affiliated Interests. Payment to affiliated interests for costs of any services, or any property, right or thing, or for interest expense shall not be allowed either as capital cost or as expense except to the extent that the regulatory authority shall find such payment to be reasonable. Any such finding of reasonableness shall include specific statements setting forth the cost to the affiliate of each item or class of items in question and a finding that the price to the utility is no higher than prices charged by the supplying affiliate to its other affiliates or divisions for the same item or items, or to unaffiliated persons or corporations.

(2) Income Taxes. If the public utility is a member of an affiliated group that is eligible to file a consolidated income tax return, and if it is advantageous to the public utility to do so, income taxes shall be computed as though a consolidated return had been so filed and the utility had realized its fair share of the savings resulting from the consolidated return, unless it is shown to the satisfaction of the regulatory authority that it was reasonable to choose not to consolidate returns. The amounts of income taxes saved by a consolidated group of which a public utility is a member by reason of the elimination

in the consolidated return of the intercompany profit on purchases by the public utility from an affiliate shall be applied to reduce the cost of the property or services so purchased. The investment tax credit allowed against federal income taxes, to the extent retained by the utility, shall be applied as a reduction in the rate based contribution of the assets to which such credit applies, to the extent and at such rate as allowed by the Internal Revenue Code.

(3) Expenses Disallowed. The regulatory authority may promulgate reasonable rules and regulations with respect to the allowance or disallowance of certain expenses for ratemaking purposes.

APPENDIX I

Excerpts from the Texas Public Utility Regulatory Act as Effective September 1, 1983

Art. 1446c. Public Utility Regulatory Act

ARTICLE I. SHORT TITLE, LEGISLATIVE POLICY, AND DEFINITIONS

Legislative policy and purpose

Sec. 2. This Act is enacted to protect the public interest inherent in the rates and services of public utilities. The legislature finds that public utilities are by definition monopolies in the areas they serve; that therefore the normal forces of competition which operate to regulate prices in a free enterprise society do not operate; and that therefore utility rates, operations and services are regulated by public agencies, with the objective that such regulation shall operate as a substitute for such competition. The purpose of this Act is to establish a comprehensive regulatory system which is adequate to the task of regulating public utilities as defined by this Act, to assure rates, operations, and services which are just and reasonable to the consumers and to the utilities.

* * * *

ARTICLE VI. PROCEEDINGS BEFORE THE REGULATORY AUTHORITY

Power to insure compliance; rate regulation

Sec. 37. Subject to the provisions of this Act, the commission is hereby vested with all authority and power of the State of Texas to insure compliance with the ob-

ligations of public utilities in this Act. For this purpose the regulatory authority is empowered to fix and regulate rates of public utilities, including rules and regulations for determining the classification of customers and services and for determining the applicability of rates. No rule or order of the regulatory authority shall be in conflict with the rulings of any federal regulatory body.

Just and reasonable rates

Sec. 38. It shall be the duty of the regulatory authority to insure that every rate made, demanded, or received by any public utility, or by any two or more public utilities jointly, shall be just and reasonable. Rates shall not be unreasonably preferential, prejudicial, or discriminatory, but shall be sufficient, equitable, and consistent in application to each class of consumers. For ratemaking purposes, the commission may treat two or more municipalities served by a public utility as a single class wherever it deems such treatment to be appropriate. Approval by the commission of a reduced rate for service for a class of consumers eligible under Section 95 of this Act for tel-assistance service does not constitute a violation of this section.

Fixing overall revenues

Sec. 39. (a) In fixing the rates of a public utility the regulatory authority shall fix its overall revenues at a level which will permit such utility a reasonable opportunity to earn a reasonable return on its invested capital used and useful in rendering service to the public over and above its reasonable and necessary operating expenses.

(b) In fixing a reasonable return on invested capital, the regulatory authority shall consider, in addition to other applicable factors, efforts to comply with the statewide energy plan, the efforts and achievements of such utility in the conservation of resources, the quality of the

utility's services, the efficiency of the utility's operations, and the quality of the utility's management.

Burden of proof

Sec. 40. Except as hereafter provided, in any proceeding involving any proposed change of rates, the burden of proof to show that the proposed change, if proposed by the utility, or that the existing rate, if it is proposed to reduce the rate, is just and reasonable shall be on the public utility. In any proceeding involving a local exchange company in which the local exchange company's rate or rates are in issue, the burden of proof that such rate or rates are just and reasonable shall be on the local exchange company.

Components of invested capital and net income

Sec. 41. The components of invested capital and net income shall be determined according to the following rules:

(a) Invested Capital. Utility rates shall be based upon the original cost of property used by and useful to the public utility in providing service including construction work in progress at cost as recorded on the books of the utility. The inclusion of construction work in progress is an exceptional form of rate relief to be granted only upon the demonstration by the utility that such inclusion is necessary to the financial integrity of the utility. Construction work in progress shall not be included in the rate base for major projects under construction to the extent that such projects have been inefficiently or imprudently planned or managed. Original cost shall be the actual money cost, or the actual money value of any consideration paid other than money, of the property at the time it shall have been dedicated to public use, whether by the utility which is the present owner or by a predecessor, less depreciation.

(b) Separations and Allocations. Costs of facilities, revenues, expenses, taxes, and reserves shall be separated or allocated as prescribed by the regulatory authority.

(c) Net Income. By "net income" is meant the total revenues of the public utility less all reasonable and necessary expenses as determined by the regulatory authority. The regulatory authority shall determine expenses and revenues in a manner consistent with the following:

(1) Transactions with Affiliated Interests. Payment to affiliated interests for costs of any services, or any property, right or thing, or for interest expense shall not be allowed either as capital cost or as expense except to the extent that the regulatory authority shall find such payment to be reasonable and necessary for each item or class of items as determined by the commission. Any such finding shall include specific findings of the reasonableness and necessity of each item or class of items allowed and a finding that the price to the utility is no higher than prices charged by the supplying affiliate to its other affiliates or divisions for the same item or class of items, or to unaffiliated persons or corporations. The price paid by gas utilities to affiliated interests for natural gas from Outer Continental Shelf lands shall be subject to a rebuttable presumption that such price is reasonable if the price paid does not exceed the price permitted by federal regulation if such gas is regulated by any federal agency or if not regulated by a federal agency does not exceed the price paid by nonaffiliated parties for natural gas from Outer Continental Shelf lands. The burden of establishing that such a price paid is not reasonable shall be on any party challenging the reasonableness of such price.

(2) Income Taxes. If the public utility is a member of an affiliated group that is eligible to file a consolidated income tax return, and if it is advantageous to the public utility to do so, income taxes shall be computed as though a consolidated return had been so filed and the utility

had realized its fair share of the savings resulting from the consolidated return, unless it is shown to the satisfaction of the regulatory authority that it was reasonable to choose not to consolidate returns. The amounts of income taxes saved by a consolidated group of which a public utility is a member by reason of the elimination in the consolidated return of the intercompany profit on purchases by the public utility from an affiliate shall be applied to reduce the cost of the property or services so purchased. The investment tax credit allowed against federal income taxes, to the extent retained by the utility, shall be applied as a reduction in the rate based contribution of the assets to which such credit applies, to the extent and at such rate as allowed by the Internal Revenue Code.

(3) Expenses Disallowed. The regulatory authority shall not consider for ratemaking purposes the following expenses:

(A) legislative advocacy expenses, whether made directly or indirectly, including but not limited to legislative advocacy expenses included in trade association dues;

(B) payments, except those made under an insurance or risk-sharing arrangement executed before the date of loss, made to cover costs of an accident, equipment failure, or negligence at a utility facility owned by a person or governmental body not selling power inside the State of Texas;

(C) Costs of processing a refund or credit under Subsection (e) of Section 43 of this Act; or

(D) any expenditure found by the regulatory authority to be unreasonable, unnecessary, or not in the public interest, including but not limited to executive salaries, advertising expenses, legal expenses, and civil penalties or fines.

No. 88-181

Supreme Court, U.S.
FILED
SEP 1 1988
CLERK

In The
Supreme Court of the United States
October Term, 1988

Houston Lighting & Power Company,
Appellant,

vs.

Public Utility Commission of Texas,
Appellee.

On Appeal from the
Supreme Court of Texas

Motion to Dismiss or Affirm

Jim Mattox
Attorney General of Texas

Mary F. Keller
First Assistant Attorney General

Larry Laurent
Assistant Attorney General
Chief, Energy Division

Karen Pettigrew*
Assistant Attorney General

P.O. Box 12548, Capitol Station
Austin, Texas 78711-2548
(512) 463-2063

Attorneys for Appellee
*Counsel of Record

September 1, 1988

Questions Presented

1. Whether this Court has jurisdiction when the issues asserted by appellant were not presented and ruled on by the Texas courts.

2. Whether the calculation of federal income taxes to be charged in appellant's rate structure must be artificially inflated to protect the appellant from a taking without compensation.

3. Whether appellant can complain of a violation of due process when it presents evidence on a particular matter, but loses on a legal ground it had not considered.

TABLE OF CONTENTS

	Page
Jurisdiction	2
Statement of the Case	2
Argument	4
1. This Court lacks jurisdiction to hear this appeal for HL&P failed to properly present the federal question of confiscation to the Texas courts for resolution.	4
2. This case presents no substantial federal questions.	9
3. The PUC's decision charging ratepayers only for the utility's actually incurred taxes does not constitute a taking without compensation.	10
4. HL&P was not denied due process in the calculation of the federal income expense charged to ratepayers.	16
Conclusion	17

TABLE OF AUTHORITIES

Cases:

Bankers Life and Casualty Co. v. Crenshaw, ___ U.S. ___, 108 S.Ct. 1645 (1988)	5
Barasch v. Pennsylvania Public Utility Commission, 516 Pa. 142, 532 A.2d 325 (1987) prob. juris. noted sub. nom. Duquesne Light Co. v. Barasch, 108 S.Ct. 1105 (1988)	9
Barasch v. Pennsylvania Public Utility Commission, 493 A.2d 653 (Pa. 1985)	12

Page

Brooks-Scanlon Co. v. Railroad Commission, 251 U.S. 396 (1920) 12
Burke v. Central Education Agency, 725 S.W.2d 393, 397 (Tex. App. - Austin 1987, writ ref'd n.r.e) 8
City of Charlottesville v. Federal Energy Regulatory Commission, 774 F.2d 1205 (D.C. Ct. 1985), cert denied, 106 S.Ct. 1575 (1986) 15
Clark v. Jeter, ___ U.S. ___, 108 S.Ct. 1910 (1988) 6
Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944) 9
Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575 (1944) 10
Federal Power Commission v. United Gas Pipeline Company, 386 U.S. 237 (1967) 15
Kaiser Aetna v. United States, 444 U.S. 164 (1979) 14
Lindsay v. Sterling, 690 S.W.2d 560 (Tex. 1985) 7
Penn. Central Transportation Co. v. City of New York, 438 U.S. 104 (1978) 14
Peralta v. Heights Medical Center, Inc., ___ U.S. ___, 108 S.Ct. 896 (1988) 6
Railroad Commission of Texas v. Bishop Petroleum, Inc. 736 S.W.2d 724 (Tex. App. - Waco 1987) aff'd in part, rev'd and rem'd in part, per curiam, 751 S.W.2d 485 (Tex. (1988) 8
Re. Southwestern Electric Power Company, 43 PUR 417 (Tex. P.U.C. 1981) 13

Page

Snead v. Texas State Board of Medical Examiners, No. 3-87-254-CV, Tex. App. - Austin, June 29, 1988 (not yet published.) 8
State ex. rel Allain v. Mississippi Public Service Commission, 435 S.W.2d 608 (Miss. 1983) 12
Street v. New York, 394 U.S. 576 (1969) 6
Suburban Utility Corporation v. Public Utility Commission, 652 S.W.2d 358, Tex. (1983) 7,11
Thor Power Tool v. Commissioner of Internal Revenue, 439 U.S. 522, 532, 99 S.Ct. 773, 781 (1979) 13
United Savings Association of Texas v. Vandygriff, 594 S.W.2d 163 (Tex. Civ. App. - Austin 1980, writ ref'd n.r.e) 7,8
Webb v. Webb, 451 U.S. 493 (1981) 5,9

Statutes:

26 U.S.C. §11(a) 14
28 U.S.C. §1257(2) 2,5,6
28 U.S.C. §1257(3) 2,5,6

Tex. Rev. Civ. Stat. Ann. art. 1446c
§2 10
§38 11
§39 11

Tex. Rev. Civ. Stat. Ann. art. 6252-13a
§16(e) 7
§19(e) 7

Page

Miscellaneous:

Edison Electric Institute, Rate Regulation Department, Regulatory Treatment of Cancelled Plants: Survey and Analysis of Cases (1986) 10

No. 88-181

IN THE
Supreme Court of the United States
OCTOBER TERM, 1988

HOUSTON LIGHTING & POWER COMPANY,
Appellant,

vs.

PUBLIC UTILITY COMMISSION OF TEXAS,
Appellee.

ON APPEAL FROM THE
SUPREME COURT OF TEXAS

Motion to Dismiss or Affirm

Pursuant to Supreme Court Rule 16.01, the Appellee Public Utility Commission of Texas ("PUC") moves to dismiss or affirm the appeal filed on behalf of Houston Lighting & Power Company ("HL&P"). The motion is grounded on the fact that the appeal is not within this Court's jurisdiction because the federal questions sought to be reviewed, which went unaddressed by state courts, were not timely or properly raised and the fact that the appeal does not present substantial federal questions.

Jurisdiction

This Court lacks jurisdiction to hear this appeal under either 28 U.S.C. §1257(2) or 28 U.S.C. §1257(3) because HL&P failed to present the federal questions to, and have them passed on by, the Texas courts.

Statement of the Case

In the underlying rate case from which this appeal arises the Texas PUC was obliged to determine the appropriate regulatory treatment for HL&P's expenses in its cancelled Allens Creek Nuclear Plant ("ACNP"). The utility abandoned this plant in the planning stages, prior to receiving a license from the Nuclear Regulatory Commission. The utility expended almost $362 million and then decided not to construct the plant. As part of a larger rate case before the PUC, Docket 4540, HL&P initiated the regulatory inquiry into the treatment of ACNP expenses. As a result of HL&P's actions, the PUC was requested to decide whether HL&P should recover all of its ACNP expenses from ratepayers, as sought by the utility, or an alternative allocation of the costs between ratepayers and shareholders.

The PUC ultimately determined that ACNP, actually cancelled on August 26, 1982, should properly have been cancelled on January 1, 1980. In regulatory terms the PUC's decision meant that

expenses incurred prior to that date were prudent and permissibly recoverable from ratepayers, but expenses incurred after that date were deemed imprudent and were not available for recovery through its rate structure. The PUC thus determined to charge the ratepayers $195 million ($19.5 million a year over a ten year period) for ACNP. This amount is in addition to the Construction Work in Progress ("CWIP") previously charged to the ratepayers in prior PUC dockets. For all prior dockets and Docket 4540, CWIP for ACNP totalled $324 million. *See* HL&P Appendix at 118a. The PUC further determined that for ratemaking purposes, the one time tax write-off by HL&P of ACNP expenses would reduce HL&P's actual incurred tax costs by $111 million. The PUC accordingly reduced the federal income tax amount charged to ratepayers by the $111 million to preclude assessing the ratepayers for a tax the utility would never pay.

Following the decision of the PUC and as a prerequisite to any appeal to the state courts, HL&P filed a 57 page motion for rehearing with the agency. In that motion HL&P made thirteen generalized references to possible constitutional claims. See Appendix I, Excerpts from HL&P's Motion for Rehearing Before the PUC. None of the references was to federal constitutional impediments to the

challenged tax computation. Moreover, HL&P only made one reference to confiscation of its property under the United States Constitution, *see Id.* at B, but that reference concerned the entire rate order, not the particular tax calculation now complained of by the utility.

Three Texas courts (district court, appellate court, and supreme court), reviewed the rate order and did not pass on the constitutional questions now urged by HL&P in its Jurisdictional Statement to this Court. Only after the Texas Supreme Court issued its opinion did the utility frame the two federal questions it seeks to present here in the form of a motion for rehearing to that Court. *See* Jurisdictional Statement at 5. The Texas Supreme Court summarily overruled the motion.

Argument

1. This Court lacks jurisdiction to hear this appeal for HL&P failed to properly present the federal question of confiscation to the Texas courts for resolution.

HL&P's principal complaint to this Court is that the PUC's calculation of federal income taxes charged to the ratepayers as a result of its cancellation of ACNP is a taking of its property without compensation. HL&P did not raise or press

this issue before the Texas courts and denied the Texas courts the opportunity to pass on it. Therefore, under the holdings of this Court, this Court should refuse review of the decision below under 28 U.S.C. §1257(2) or 28 U.S.C. §1257(3).

This case is directly analogous to *Bankers Life and Casualty Co. v. Crenshaw*, ___ U.S. ___, 108 S.Ct. 1645 (1988). There, the appellant did not raise the appropriate federal question in its appeal to the Mississippi Supreme Court but merely urged a generalized constitutional argument in its motion for rehearing. *Id.* at 1649. This Court held that the federal question was not properly raised by appellant in the Mississippi Courts, thus denying the Mississippi Courts the opportunity to adjudicate the issues appellant later sought to have reviewed by the Supreme Court. *Id.* at 1650. In reaching this holding the Court relied on and quoted *Webb v. Webb*, 451 U.S. 493, 501 (1981):

> [a]t a minimum . . . there should be no doubt from the record that a claim under a *federal* statute or the *Federal* Constitution was presented in the state courts and that those courts were apprised of the nature and substance of the federal claim at the time and in the manner required by the state law.

Bankers Life and Casualty Co. v. Crenshaw, ___ U.S. at ___, 108 S.Ct. at 1650.

The need to properly present the federal questions is equally applicable, whether this Court's jurisdiction is sought under 28 U.S.C. §1257(2) or 28 U.S.C. §1257(3). *Id. Clark v. Jeter*, ___ U.S. ___, ___, 108 S.Ct. 1910, 1913 (1988). *See also Peralta v. Heights Medical Center, Inc.*, ___ U.S. ___, ___, 108 S.Ct. 896, 898 n.4 (1988). Additionally, this Court has repeatedly held

> that when, as here, the highest state court has failed to pass upon a federal question, it will be assumed that the omission was due to want of proper presentation in the state courts, unless the aggrieved party in this Court can affirmatively show the contrary.

Street v. New York, 394 U.S. 576, 582 (1969).

HL&P not only did not raise the federal question of taking without compensation with the Texas courts, but under Texas law the utility, through its own fault, could not have raised the question. HL&P's motion for rehearing before the PUC must have included specific reference to its federal confiscation claim urged before this Court to confer jurisdiction on the Texas courts to consider the claim. It did not. *See* Appendix I at B.

Texas law requires that upon issuance of a final agency order a party must file a motion for rehearing before the administrative agency and have such motion overruled as a jurisdictional prerequisite to review of the agency's order by Texas courts. TEX. REV. CIV. STAT. ANN. art. 6252-13a §§16(e), 19(e) (Supp. 1988) ("APTRA"); *Lindsay v. Sterling*, 690 S.W.2d 560, 563 (Tex. 1985). The motion for rehearing must not only be timely filed but also must specify the particular error of the agency complained about, e.g., finding of fact, conclusion of law, ruling or other action, and the legal basis for the claimed error. APTRA §16(e). *See Suburban Utility Corporation v. Public Utility Commission*, 652 S.W.2d 358, 365 (Tex. 1983).

Texas courts have repeatly held that the claimed error will be waived unless the motion for rehearing is ". . . sufficiently definite to apprise the [agency] of the error claimed and to allow the [agency] opportunity to correct the error or to prepare to defend it." *United Savings Association of Texas.v. Vandygriff*, 594 S.W.2d 163, 168 (Tex. Civ. App. - Austin 1980, writ ref'd n.r.e.).[1] A motion for rehearing

---

1 The court further held:

> For the agency to be able to correct its errors, it must be on notice as to what the movant alleges constitutes error. Technical specificity is not required, it is true, but the agency should not

is not sufficiently specific to confer jurisdiction if the errors complained of are merely alleged in a generalized format. *Burke v. Central Education Agency*, 725 S.W.2d 393, 397 (Tex. App. - Austin 1987, writ ref'd n.r.e). ("To generalize . . . is to omit; and, to omit is to render doubtful what is intended to be included in such overly broad assignments of error.") *Snead v. Texas State Board of Medical Examiners*, No. 3-87-254-CV, Tex. App. - Austin, June 29, 1988 (not yet published).

HL&P could not, and did not, press the federal taking without compensation claim before the Texas courts. The Texas courts could not, and did not, pass on the claim. Accordingly, the federal claims now

---

> be put in a position of having to guess what error is alleged. If any lesser degree of specificity had been intended by the legislature, we must presume that it would have provided for a mere 'notice of appeal' . . .

United Savings Association of Texas v. Vandygriff, 594 S.W.2d at 170. *See also Railroad Commission of Texas v. Bishop Petroleum, Inc.*, 736 S.W.2d 724, 744 (Tex. App. - Waco 1987), aff'd in part, rev'd and rem'd in part, per curiam, 751 S.W.2d 485 (Tex. 1988) (Court did not acquire jurisdiction to consider blanket allegations that an agency had violated every error listed in APTRA, Section 19(e) when the agency did not attack the blanket allegations in its plea to the jurisdiction.).

presented by HL&P were not properly raised below, and this Court is without jurisdiction to review them.[2]

2. This case presents no substantial federal questions.

This Court should refuse to hear this appeal as it presents no substantial federal issues. The PUC's decision in calculating federal income taxes charged to the ratepayers as a result of the cancellation of ACNP is but one of hundreds of decisions which constitute the final rates ordered in the case in Docket 4540. This Court has counselled that it will not review particular calculations by a regulatory body if the end result of the case as a whole is fair to utility ratepayers and shareholders alike. *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).[3] Furthermore, since

---

[2] The policy reasons behind the state requirement for a motion for rehearing to secure judicial review of an agency order and the courts' requirement that an issue be presented to and passed on by state courts prior to its review are the same. In both cases the entity first charged with inquiring into a particular question should be given the opportunity to develop the record and decide the question. *Webb v. Webb*, 451 U.S. at 500.

[3] The case is thus not similar to *Barasch v. Pennsylvania Public Utility Commission*, 516 Pa. 142, 532 A.2d 325 (1987), *prob. juris. noted sub. nom. Duquesne Light Co. v. Barasch*, 108 S.Ct. 1105 (1988). There the Pennsylvania Supreme Court held that a state statute precluded *any* recovery by the utility for expenses in a cancelled plant. Here the utility recovered -- and the ratepayers are obligated to pay -- $195 million of the $362 million spent for a plant that was never built and that never

regulatory bodies have already virtually completed the treatment of cancelled nuclear plants, *see* Edison Electric Institute, Rate Regulation Department, *Regulatory Treatment of Cancelled Plants: Survey and Analysis of Cases* at 5 (regulatory bodies in 34 jurisdictions heard 94 cases involving cancellation of nuclear power plants between 1977 and 1986), the need for guidance from this Court has come and gone, if it ever existed.

3. The PUC's decision charging ratepayers only for the utility's actually incurred taxes does not constitute a taking without compensation.

This Court has equated compliance with the just and reasonable standard for setting utility rates to compliance with the confiscation standard of the fifth amendment of the United States Constitution. *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586, 62 S.Ct. 736, 743 (1944). The Texas Public Utility Regulatory Act ("PURA"), TEX. REV. CIV. STAT. ANN. art. 1446c (Vernon Supp.

---

generated electricity. This charge to ratepayers is in addition to CWIP previously allowed by the PUC for ACNP. Moreover, the regulatory body did not preclude the utility from utilizing the federal income tax write-off allowed by federal law. Unlike the Pennsylvania utilities, HL&P has not been denied recovery of expenses.

1988), specifically adopts this constitutional criteria for rates charged by a particular utility. PURA §§2, 38. Section 2 of PURA provides, in part:

> The purpose of this Act is to establish a comprehensive regulatory system which is adequate to the task of regulating public utilities . . ., to assure rates, operations, and services which are just and reasonable to the consumers and to the utilities.

One component of setting just and reasonable rates is the determination of operating expenses. In establishing appropriate criteria, section 39 of PURA provides:

> In fixing the rates of a public utility the regulatory authority shall fix its overall revenue at a level which will permit such utility to recover its operating expenses together with a reasonable return on its invested capital.

PURA, §39 (Supp. 1981). The Texas Supreme Court has determined that operating expenses must be allowed when such expenses are actually, reasonably and necessarily incurred. *Suburban Utility Corporation v. Public Utility Commission*, 652 S.W.2d at 363. Therefore, following its statutory mandate and applicable legal precedent, the PUC reviewed HL&P's treatment of federal income tax

expense and determined that as a result of the write-off of ACNP, the utility's taxes would be lowered. Had the PUC refused to take into account the impact of the ACNP tax write-off, the ratepayers would have been allocated a disproportionately high federal income tax expense, which expense would have been a hypothetical not actual expense as required by PURA.[4] The PUC's treatment of the tax expense item thus complied with its statutory and constitutional mandate to set just and reasonable rates.[5]

To support its claim of taking without compensation, HL&P asserts that disallowed expenses become nonutility property. HL&P Jurisdictional Statement at 13-16. HL&P is impliedly relying on an accounting methodology utilized by

---

4 *Accord e.g., Barasch v. Pennsylvania Public Utility Commission*, 493 A.2d 653, 655 (Pa. 1985); *State ex. rel Allain v. Mississippi Public Service Commission*, 435 S.W.2d 608, 618 (Miss. 1983).

5 HL&P incorrectly cites *Brooks-Scanlon Co. v. Railroad Commission*, 251 U.S. 396 (1920), for the proposition that non-utility property cannot be used to subsidize utility rates. *Brooks-Scanlon* involved a company one of whose holdings was a rail line. The rail line was unprofitable and the company discontinued its use. The state regulatory body ordered the company to go back into business at rates below the cost of service on the line. This Court found "A carrier cannot be compelled to carry on even a branch of business at a loss, much less the whole business of carriage." *Id.* at 184, 399. The Court in effect ordered the regulatory body to recognize the utility's actual costs. The PUC did exactly that in the case on appeal here.

regulated industries and regulatory bodies for reporting purposes. The methodology provides that when expenses are disallowed, such expenses may be reclassified as nonutility "property." *See* Amicus Curiae Brief of Arthur Anderson & Co. at 3-5. HL&P then asserts that the tax effects of the reclassified property are likewise reclassified as nonutility "property." HL&P's reliance on a method of keeping accounts to label property for *all* regulatory purposes oversteps the bound of reason.[6]

First, while the accounting methodology relied on by HL&P is a mechanism for reporting information to the PUC and other regulatory bodies, the use of any particular mechanism for information reporting does not foreclose the PUC from fully examining the operations of the utility to set just and reasonable rates. *Re. Southwestern Electric Power Company*, 43 P.U.R. 417, 421 (Tex. P.U.C. 1981); *Cf. Thor Power Tool v. Commissioner of Internal Revenue*,

---

6 *All* of the expenses related to a cancelled plant are not de facto utility expenses in the traditional sense. Such expenditures provide nothing that benefits the ratepayer; nothing is used and useful, nothing is dedicated to the public service. The treatment of cancelled plant expenses and how to balance the costs between ratepayers and shareholders cannot be construed in the same light as the standard inquiry into operating expenses or into adding plant costs to ratebase. The regulators must determine how to continue to encourage investment in new facilities and yet not penalize the ratepayer with an unreasonable cost for a power plant that is not and will not be functional.

439 U.S. 522, 532, 99 S.Ct. 773, 781 (1979) (authority of Internal Revenue Commissioner to disallow a particular accounting methodology if it did not accurately reflect the taxpayer's income).

Second, HL&P does not, and cannot, assert that the tax write-off of ACNP expenses was taken by the PUC from the taxpaying entity entitled to utilize the tax savings. Federal income tax law assesses taxes against corporations. 26 U.S.C. §11(a). Tax deductions, including the abandonment of investment such as the cancellation of ACNP, beneficially accrue to the corporation for purposes of determining its federal income tax expense. Shareholders are not individually billed for their portion of the corporation's federal income taxes, if any. Shareholders of a utility only have an income tax obligation to the extent that dividends are lower because ratepayers are not charged for the corporation's total taxes.[7]

---

7 HL&P asserts that the PUC's calculation of taxes to be charged to ratepayers as a result of the ACNP cancellation is impermissible confiscation under this Court's decisions. HL&P incorrectly applies the cases relied on. In *Kaiser Aetna v. United States*, 444 U.S. 164 (1979), this Court, citing *Penn Central Transportation Co. v. City of New York*, 438 U.S. 104, 124 (1978), listed the economic impact of regulation, interference with investment based expectations, and the character of the government action as criteria to determine whether there has been an uncompensated taking. Here, the result of the calculation of federal taxes does not alter HL&P's ability to utilize the tax deduction when reporting to the Internal Revenue Service; investors in the company have benefited from the amount contributed by the ratepayer to the costs of ACNP; and

Third, the utility's argument rests solely on the proposition that the only constitutionally permissible methodology for calculating tax expenses for regulatory purposes is the methodology which ties the tax "benefits" to expenses as they have been classified for accounting purposes. To the contrary, the "actual taxes incurred" or "flow through methodology" used by the PUC in this case was found acceptable by this Court in *Federal Power Commission v. United Gas Pipeline Company*, 386 U.S. 237 (1967). Subsequent to this Court's holding in *United Gas Pipeline*, the federal agency regulating utilities determined to change its method of calculating taxes. That new method was challenged and the federal appeals court likewise found the alternative method acceptable. *City of Charlottesville v. Federal Energy Regulatory Commission*, 774 F.2d 1205, 1216 (D.C. Ct. 1985), cert denied, 106 S.Ct. 1575 (1986). In *City of Charlottesville* the court wrote: "Within certain rational limits . . ., which approach to choose [for calculating taxes] is more a matter of regulatory policy than of logic." *Id.* at 1221. Thus, when the PUC was faced with a choice between two methods of calculating income taxes for purposes of determining rates, and both proposed

---

the PUC exercised its statutory and constitutional obligation to set just and reasonable rates when it made the tax calculation.

methods are permissible, the PUC was not bound by HL&P's preference.

For the above reasons, HL&P is incorrect in its position that the PUC has taken its property without compensation. Rather, the PUC has properly followed its constitutional and statutory mandate to set just and reasonable rates.

4. HL&P was not denied due process in the calculation of the federal income expense charged to ratepayers.

The utility, almost as an afterthought, urges this Court to review the decision below because of an alleged violation of the Fourteenth Amendment. Perhaps the issue is included because, although it failed here too, HL&P came closer to preserving it for review by Texas courts that it did with the taking issue. Nevertheless, HL&P did not properly preserve or press the federal due process question so as to avail the Texas courts an opportunity to pass on it. *See* generally discussion at pages 4-7 above.

Furthermore, HL&P is disingenuous in complaining of lack of notice of one particular part, the calculation of federal tax expense charged to ratepayers, of the ultimate treatment of expenses for the cancelled nuclear plant. The issue of the regulatory treatment of the cancellation of ACNP was initiated by HL&P at the PUC. HL&P Appendix at

116a. The utility recognized that there were federal income tax issues resulting from the cancellation of the plant. *Id.* The cancellation of ACNP was addressed extensively during the administrative proceeding. *Id.* at 113a-139a. Furthermore, the administrative record specifically includes HL&P's challenge to the actual dollar amount of the tax computation and additional explanation by the agency staff to the PUC Commissioners of that calculation. HL&P's federal due process rights are not violated whenever it presents evidence on a matter, but loses on a legal ground it had not considered.

Conclusion

The Court should dismiss or affirm the decision of the Texas Supreme Court because the federal questions were not properly raised and passed on by Texas courts and because this appeal does not present a substantial federal question.

Respectfully submitted,

JIM MATTOX
Attorney General of Texas

MARY F. KELLER
First Assistant Attorney General

LARRY LAURENT
Assistant Attorney General
Chief, Energy Division

KAREN PETTIGREW*
Assistant Attorney General

P.O. Box 12548, Capitol Station
Austin, Texas 78711-2548
(512) 463-2003
Attorneys for Appellee

September 1, 1988

**Counsel of Record*

Excerpts from HL&P's Motion for Rehearing Before the PUC

A. At page 2:

> "In view of this incomplete record, the Commission's addition of a finding of mismanagement is not supported by substantial evidence, is arbitrary and capricious, deprives HL&P of due process and threatens the interests of the other project Participants, who were not afforded a right to be heard."

B. At page 5:

> "The Commission's Final Order fails to conform to the standards established by the Public Utility Regulatory Act . . . and the Administrative Procedure and Texas Register Act . . . Unless the Commission undertakes to correct the errors contained in the Final Order, and the Examiner's Report adopted therein . . . HL&P will have been denied its rights to due process of law and will suffer confiscation of its property in contravention of the guarantees of the Constitutions of the United States and the State of Texas."

C. At page 7:

> "The Commission's findings on STP (South Texas Project) are not supported by the record, are arbitrary, capricious and beyond the Commission's legal authority. The

findings deprive HL&P of both substantive and procedural due process."

D. At page 13:

"This Commission has made sweeping, all encompassing findings with reference to HL&P's management of STP without giving HL&P an opportunity to be heard. This procedure violates the fundamentals of due process . . . HL&P had a right to clear notice that it was expected to make a full case on STP and that sweeping findings as to STP were contemplated in this docket."

E. At page 14:

"A deprivation of due process (i.e. a procedure by which significant findings are made without giving a party an adequate opportunity to be heard) is, of course inherently unlawful and basically bad; however there are concrete practical detriments which are imposed upon HL&P's ratepayers by the Commission's unsupported findings."

F. At page 16:

"The findings of administrative bodies, such as the Commission . . . normally, are the result of a deliberate hearing process in which all interested parties have presented all the relevant evidence and had an opportunity to

cross-examine adverse witnesses. As noted above, however, the Commission's findings concerning STP are not the result of such a process because neither HL&P nor the staff presented affirmative, complete evidence as to STP."

G. At page 19:

"The verbal thrashing which the Commission has imposed upon HL&P relating to STP is thus not only unsupported by the record, a violation of due process, affirmatively harmful to the consumers of electric power, it is *totally gratuitous.*" (emphasis in original).

H. At page 19-20:

"Advisory rulings as to the treatment of lawsuit results without regard to the findings in the suit and the evidence which will ultimately be adduced in the suit and in the management review contemplated by the procedure established in Docket No. 3320 is inconsistent as well as being an unlawful denial of due process."

I. At page 31:

"None of the circumstances cited as a basis for Finding of Fact No. 21 was a factor known only to HL&P . . . all such circumstances were known and acknowledged by the Commission . . . Yet the Commission itself never

suggested cancellation of Allens Creek. For the Commission to now determine it was imprudent not to cancel the plant by January 1, 1980 is not only arbitrary and capricious but in violation of constitutional and statutory provisions."

J. At page 35: HL&P claims that the PUC engaged in improper rate-making in adopting a treatment of benefits in a way which required HL&P to bear the burden of a disallowance of $166 million of the Allens Creek expenditures, but which did not allow HL&P to retain any tax benefits arising from those expenses:

> "It is not lawful under the Utility Act or the Texas Constitution to, on the one hand, preclude recovery through rates of expenses on the grounds of imprudence and, at the same time, use those same expenses for determining the regulatory allowance for income taxes."

K. At page 39:

> "The Commission erred in reducing the cost of equity by .5% to 16.35% (Revenue Ruling Modification B; Finding of Fact No. 10) for the following reasons:
>
> (a) Such action is in violation of HL&P's constitutional rights in that it results in a taking of HL&P's property without just compensation."

L. At page 43 HL&P states that the Commission erred in finding that HL&P mismanaged STP:

> "Such finding was made in violation of HL&P's rights to due process under the United States and Texas Constitutions as a result of the failure of the Commission to give notice that HL&P's management practices at STP were to be an issue in this proceeding."

M. At page 51:

> "The Commission erred in finding that the tax savings associated with the expenditures for Allens Creek disallowed by the Commission should be flowed through to the rate payers for the following reasons:
>
> (a) Such finding violates HL&P's right of due process in that such conclusion was reached without notice and fair opportunity to comment."

FILED
SEP 8 1988
JOSEPH E. SPANIOL, JR.
CLERK

No. 88-181

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

HOUSTON LIGHTING & POWER COMPANY,
Appellant,

v.

PUBLIC UTILITY COMMISSION OF TEXAS,
Appellee.

On Appeal from the Supreme Court of Texas

REPLY TO APPELLEE'S MOTION TO DISMISS OR AFFIRM

HUGH RICE KELLY
HOUSTON LIGHTING & POWER COMPANY
Post Office Box 61867
Houston, TX 77208
(713) 229-7265

ROBERT J. HEARON, JR.
GRAVES, DOUGHERTY, HEARON & MOODY
Post Office Box 98
Austin, TX 78767
(512) 480-5600

EDGAR M. ROACH, JR.*
HUNTON & WILLIAMS
One Hannover Square
Raleigh, NC 27601
(919) 899-3000

GREGORY EVERS MAY
LYNDA GUILD SIMPSON
HUNTON & WILLIAMS
2000 Pennsylvania Ave., N.W.
Washington, DC 20006
(202) 955-1500

Attorneys for Houston Lighting & Power Company

* Counsel of Record

September 8, 1988

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

RULE 28.1 STATEMENT

Pursuant to Rule 28.1, appellant notes that there have been no changes in the parent company, subsidiaries, and affiliates of Houston Lighting & Power Company since the Jurisdictional Statement was filed.

TABLE OF CONTENTS

Page

I. This Court Has Jurisdiction Because HL&P Raised the Federal Questions Before the PUC and the Texas Courts 2

II. The Federal Questions Presented by This Case Are Substantial 4

III. The Allocation to Ratepayers of Tax Benefits for Disallowed Investment Is an Unconstitutional Taking 5

IV. The Allocation of Tax Benefits for Disallowed Investment Without Any Basis in the Record Is a Denial of Due Process 6

CONCLUSION 7

TABLE OF AUTHORITIES

CASES

Bankers Life & Casualty Co. v. Crenshaw, 108 S.Ct. 1645 (1988) 4

Baptist Hospital v. Baber, 714 S.W.2d 310 (Tex. 1986) 3

Brooks-Scanlon Co. v. Railroad Comm'n, 251 U.S. 396 (1920) 5

Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944) 4

Federal Power Comm'n v. United Gas Pipe Line Co., 386 U.S. 237 (1967) 6

San Antonio General Drivers & Helpers Local 657 v. Thornton, 299 S.W.2d 911 (Tex. 1957) 3

Singleton v. Pennington, 568 S.W.2d 367 (Tex. Civ. App. 1978), *rev'd on other grounds*, 606 S.W.2d 682 (Tex. 1980) 4

Suburban Utility Corp. v. Public Utility Comm'n, 652 S.W.2d 358 (Tex. 1983) 2

Wright v. Gernandt, 559 S.W.2d 864 (Tex. Civ. App. 1977) 4

STATUTE

Tex. Rev. Civ. Stat. Ann. art. 6252-13a, § 16(e) 2

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

No. 88-181

HOUSTON LIGHTING & POWER COMPANY,
Appellant,

v.

PUBLIC UTILITY COMMISSION OF TEXAS,
Appellee.

On Appeal from the Supreme Court of Texas

REPLY TO APPELLEE'S MOTION TO DISMISS OR AFFIRM

In its motion to dismiss or affirm, appellee Public Utility Commission of Texas ("Appellee" or the "PUC") argues that the appeal of Houston Lighting & Power Company ("HL&P") should be dismissed because (i) the federal questions were not timely raised and (ii) no substantial federal questions have been presented. Those arguments miss their mark. Appellee has failed either to show that this Court lacks jurisdiction or to rebut the Jurisdictional Statement's demonstration that this appeal presents federal questions of national importance.

I. This Court Has Jurisdiction Because HL&P Raised the Federal Questions Before the PUC and the Texas Courts.

Section 16(e) of the Texas Administrative Procedure Act provides that parties to a proceeding before the PUC may not challenge the PUC's order in court without first raising their objection with the PUC through a motion for rehearing. Tex. Rev. Civ. Stat. Ann. art. 6252-13a, § 16(e) (Supp. 1988). Appellee contends that HL&P failed to raise the takings clause issue presented by this appeal in its motion for rehearing before the PUC. By its own record and case citations, however, Appellee shows that HL&P did preserve the federal question.

HL&P's motion for rehearing before the PUC asserted that "The Commission Erred in its Findings of Fact and Conclusions of Law Relating to the Allens Creek Cancellation." Under that heading appeared a subsection entitled "The Improper Treatment of Federal Income Taxes Associated with Allens Creek Cancellation," in which HL&P made the same argument now presented in its Jurisdictional Statement: that the Commission improperly allocated to ratepayers the tax benefits associated with the disallowed costs of the Allen's Creek Nuclear Project ("ACNP"). As shown in Appellee's Appendix 1, paragraph B, the motion for rehearing stated that unless the PUC's order were changed to correct the errors enumerated, "HL&P will have been denied its rights to due process of law and will suffer confiscation of its property in contravention of the guarantees of the Constitutions of the United States and the State of Texas."

Under the Texas cases that Appellee cites, HL&P's motion for rehearing before the PUC plainly was sufficient to preserve the federal issues for purposes of section 16(e). In *Suburban Utility Corp. v. Public Utility Commission*, 652 S.W.2d 358 (Tex. 1983), the Texas Supreme Court ruled that the purpose of a motion for rehearing under section 16(e) is simply to give the agency notice that the

movant is dissatisfied with the agency's ruling and will appeal unless the ruling is changed. The motion need only be "sufficiently definite to apprise the regulatory agency of the error claimed and to allow the agency opportunity to correct the error or to prepare to defend it." *Id.* at 365. The court specifically rejected the suggestion that a motion for rehearing should be as specific as pleadings required in judicial proceedings. *Id.* at 364. The PUC therefore had adequate notice of both HL&P's dissatisfaction with the agency's ruling and the legal basis for the dissatisfaction.

HL&P preserved the federal issues raised before the PUC throughout proceedings in the Texas courts. Appellee's contention that HL&P waived its federal constitutional claims because they were not addressed by the Texas courts ignores the procedural history of this case. HL&P's pleadings in the state district court repeated the claims of error presented in its motion for rehearing before the PUC. The district court and the court of appeals did not reach HL&P's federal constitutional claims because they ruled for HL&P on state law grounds. They concluded that state law requires tax benefits to follow the investment to which the benefits relate. *See* App. at 27a-30a, 38a. Texas courts are prohibited by state law from addressing a constitutional issue if the case can be decided on other grounds. *Baptist Hospital v. Baber*, 714 S.W.2d 310 (Tex. 1986); *San Antonio General Drivers & Helpers Local 657 v. Thornton*, 299 S.W.2d 911, 915 (Tex. 1957). The first opportunity for the state courts to address the federal issues came only when the Texas Supreme Court reversed the court of appeals' and district court's rulings. At that point, HL&P promptly, properly, and precisely raised the federal constitutional issues in its motion for rehearing before that court.[1] *See*

[1] The specificity with which HL&P raised its federal constitutional claims, both in its motion for rehearing before the PUC and in its petition for rehearing before the Texas Supreme Court, distinguish

Appellant's Supplemental Appendix, *infra*; *see also Singleton v. Pennington*, 568 S.W.2d 367, 375 (Tex. Civ. App. 1978), *rev'd on other grounds*, 606 S.W.2d 682 (Tex. 1980); *Wright v. Gernandt*, 559 S.W.2d 864, 872 (Tex. Civ. App. 1977).

II. The Federal Questions Presented by This Case Are Substantial.

The central question presented by this appeal is whether *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), provides the appropriate standard of review where state utility regulators have taken nonutility property in order to reduce rates. Appellee argues that the appeal raises no substantial question because the PUC's decision to allocate tax benefits to ratepayers was merely part of an overall rate calculation reviewable under *Hope*. By assuming that *Hope* governs, Appellee completely overlooks the important constitutional question presented. The standard of review set by *Hope* and its progeny determines the adequacy of compensation received by utilities through rates for the value of utility property dedicated to public use. That standard does not apply here, where the PUC has appropriated the value of *nonutility* property and used it to reduce rates payable for the public use of *utility* property. Appellee's response does not show that there is no substantial federal question; it instead demonstrates the blindness of state regulators to an important constitutional issue on which this Court's guidance sorely is needed.

---

this case from *Bankers Life & Casualty Co. v. Crenshaw*, 108 S.Ct. 1645 (1988), in which this Court recently ruled that claims under the contract and due process clauses had not been raised properly in a petition for rehearing before the Mississippi Supreme Court. In that case, the appellant alleged only that the punitive damage award "was clearly excessive, not reasonably related to any legitimate purpose, constitutes excessive fine, and violates constitutional principles." *Id.* at 1649.

III. The Allocation to Ratepayers of Tax Benefits for Disallowed Investment Is An Unconstitutional Taking.

HL&P's abandonment loss deduction for ACNP reduces the amount of federal income tax paid, but not the amount actually incurred with respect to public utility operations. Appellee contends that if the PUC had not awarded to ratepayers the entire tax benefit associated with that deduction, HL&P would have recovered through rates a "hypothetical expense"—a tax expense it would not actually incur. Appellee completely misunderstands the tax accounting principles involved here. HL&P incurs tax expenses related to the provision of utility services. Whether it pays those expenses with cash or by offsetting income tax deductions against them, the expenses nonetheless actually are incurred.

The relevant fact, which Appellee ignores, is that the tax deductions used to offset utility tax expense in this case related to nonutility property. The PUC allocated to ratepayers not just the tax deductions associated with the ACNP investment included in rate base, but also the deductions associated with the disallowed investment. HL&P is entitled to enjoy the benefit of the deductions relating to the ACNP investment for which it will receive no rate recovery. Otherwise, the PUC will have taken the value of nonutility property without compensation and awarded it to the ratepayers in further reduction of their rates for the use of utility property.[2]

---

[2] The distinction between utility and nonutility property is not just an accounting mechanism as Appellee asserts. That distinction is central to a state's power to regulate utility rates and to the question whether a utility has received just compensation under the Fifth Amendment for the use of its property. While the state has the power to regulate the amount of compensation a utility receives for the dedication of its *utility* property to public use, it has no power to bestow on the ratepayers the value of *nonutility* property that has not been dedicated to the public use. *Brooks-Scanlon Co. v. Railroad Commission*, 251 U.S. 396 (1920), so holds. *See* Jurisdictional Statement at 16.

Appellee's reliance on *Federal Power Commission v. United Gas Pipe Line Co.*, 386 U.S. 237 (1967), as support for the PUC's method of calculating taxes is unwarranted. That case ruled only that the method of calculation involved there was permissible as a matter of regulatory accounting; the constitutional question at issue here involving the proper allocation of tax benefits associated with nonutility property was not addressed.[3]

IV. The Allocation of Tax Benefits for Disallowed Investment Without Any Basis in the Record Is a Denial of Due Process.

Appellee's own Appendix at page 5a, paragraph M, shows that HL&P specifically preserved its federal due process claim for review. The hearing examiner's report on ACNP, found in HL&P's Appendix at 113a-139a, shows the basis for that claim. That report contains no mention of the allocation of tax benefits because the issue was not raised or addressed in the agency hearing. Moreover, the record of the hearing contains no evidence showing how the benefits were to be calculated.[4] The PUC's decision on this issue was arbitrary, capricious, and without any basis in the record. The decision therefore denied HL&P's federal constitutional right to due process.

---

[3] Appellee's contention that the PUC's decision passes constitutional muster because it does not prevent HL&P from taking the tax deduction begs the question entirely. Whether the PUC forbids HL&P to take the tax deduction or, as actually happened, permits it to take the deduction but lowers rates by a concomitant amount, the economic result is exactly the same. Under the circumstances, HL&P's ability to enter the deduction on its tax return is a hollow pleasure.

[4] The "additional explanation" of the calculation to which the Appellee refers, Appellee's Motion at 17, was an internal PUC staff memorandum not disclosed to HL&P until after the PUC had entered its final order.

CONCLUSION

For the reasons stated here and in the Jurisdictional Statement, the Court should note probable jurisdiction and set this case for argument. The federal questions were properly raised and preserved for appeal, and they present issues of national importance to the utility industry.

Respectfully submitted,

HUGH RICE KELLY
HOUSTON LIGHTING & POWER COMPANY
Post Office Box 61867
Houston, TX 77208
(713) 229-7265

ROBERT J. HEARON, JR.
GRAVES, DOUGHERTY, HEARON & MOODY
Post Office Box 98
Austin, TX 78767
(512) 480-5600

EDGAR M. ROACH, JR.*
HUNTON & WILLIAMS
One Hannover Square
Raleigh, NC 27601
(919) 899-3000

GREGORY EVERS MAY
LYNDA GUILD SIMPSON
HUNTON & WILLIAMS
2000 Pennsylvania Ave., N.W.
Washington, DC 20006
(202) 955-1500

Attorneys for Houston Lighting & Power Company

* Counsel of Record

September 8, 1988

SUPPLEMENTAL APPENDIX

Excerpts from HL&P's Motion for Rehearing Before the Supreme Court of Texas

A. At Page 3:

II.

The Court's opinion and judgment is in error in holding and decreeing that "The utility's rates must reflect the tax liability actually incurred" because such holding, if construed to require inclusion of tax savings arising from non-utility costs or expenses in the determination of tax liability, violates fundamental concepts of utility ratemaking adopted by statute, and results in an unconstitutional taking of property for public use without compensation.

B. At Page 8:

VII.

The Court's holding that the tax savings generated from the $166 million of disallowed ACNP expenses should inure to the benefit of ratepayers is in error because it is a taking of private property for public use without just compensation, and is unconstitutional.

C. At Page 9:

The allocation to ratepayers of the tax benefits associated with the $166 million ACNP cancellation loss denies HL&P the just compensation guaranteed by the Texas and U.S. Constitutions in two distinct ways—taking property from HL&P's shareholders for public use without just compensation and setting rates which deny HL&P the recovery of its prudent operating expenses.

D. At Page 10:

VIII.

The Court's holding that the tax savings generated from the $166 million of disallowed ACNP expenses should inure to the benefit of ratepayers is in error because it is a violation of constitutional due process requirements.

E. At Page 10:

The allocation to ratepayers of the tax benefits related to the $166 million in disallowed ACNP investment constitutes an unreasonable and arbitrary deviation from well established and accepted accounting and regulatory principles, violating both the due process and equal protection clauses of the Texas and United States Constitutions.

F. At Page 11:

HL&P has been deprived of procedural due process concerning the treatment of the tax savings. No evidence was presented and no arguments were made at the hearing regarding the tax treatment of the $166 million disallowance. The Examiner's Report did not discuss the tax treatment. The issue was first addressed in the Commission's Final Order. That Order was without evidentiary basis.

88-181

(3)

Supreme Court, U.S.
FILED
AUG 1 1988
JOSEPH F. SPANIOL, JR.
CLERK

No. 88-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

HOUSTON LIGHTING & POWER COMPANY,
Appellant,

v.

PUBLIC UTILITY COMMISSION OF TEXAS,
Appellee.

On Appeal from the Supreme Court of Texas

BRIEF OF EDISON ELECTRIC INSTITUTE AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT'S JURISDICTIONAL STATEMENT

JAN J. SAGETT *
PETER B. KELSEY
WILLIAM L. FANG
EDISON ELECTRIC INSTITUTE
1111 19th Street, N.W.
Washington, D.C. 20036
(202) 778-6616
Attorneys for
Edison Electric Institute

August 1, 1988

* Counsel of Record

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

QUESTION PRESENTED

Whether a public utility rate order takes property without just compensation in violation of the Fifth and Fourteenth Amendments to the United States Constitution when it gives to ratepayers the benefit of a tax deduction arising from costs that were not paid by the ratepayers.

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
TABLE OF AUTHORITIES	iv
INTEREST OF THE *AMICUS CURIAE*	1
SUMMARY OF ARGUMENT	3
THE QUESTIONS PRESENTED ARE SUBSTANTIAL	4
I. THIS CASE PRESENTS AN ISSUE OF NATIONAL IMPORTANCE	4
II. THIS CASE PRESENTS AN IMPORTANT CONSTITUTIONAL ISSUE NOT PREVIOUSLY ADDRESSED BY THIS COURT	8
A. This Case Involves a Taking of HL&P's Nonutility Property Not Governed by This Court's Decision in *Hope Natural Gas* and Its Progeny	8
B. Under Standard Fifth Amendment Principles, the Decision of the Texas Supreme Court Effected a Taking of HL&P's Property Without Compensation	10
CONCLUSION	14

TABLE OF AUTHORITIES

CASES

	Page
Armstrong v. United States, 364 U.S. 40 (1960)	12
Barasch v. Pennsylvania Pub. Util. Comm'n, 516 Pa. 142, 532 A.2d 125 (1984), *prob. juris. noted sub nom. Duquesne Light Co. v. Barasch*, 108 S. Ct. 1105 (1988)	6
Bluefield Waterworks & Improvement Co. v. Public Serv. Comm'n, 262 U.S. 679 (1923)	9
Board of Pub. Util. Comm'rs v. New York Tel. Co., 271 U.S. 23 (1926)	9
Brooks-Scanlon Co. v. Railroad Comm'n, 251 U.S. 396 (1920)	9, 11
Connolly v. Pension Benefit Guar. Corp., 475 U.S. 211 (1986)	12
Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944)	6
Hodel v. Irving, 107 S. Ct. 2076 (1987)	13
Kaiser Aetna v. United States, 444 U.S. 164 (1979)	10, 11
Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276 (1923)	9
Munn v. Illinois, 94 U.S. 113 (1877)	9, 11
New York ex rel. New York & Queens Gas Co. v. McCall, 245 U.S. 345 (1917)	9
Penn Cent. Transp. Co. v. New York City, 438 U.S. 104 (1978)	4, 11
In re Permian Basin Area Rate Cases, 390 U.S. 747 (1968)	6, 9
Ruckelshaus v. Monsanto Co., 467 U.S. 986 (1984)	4, 10, 11, 13
Webb's Fabulous Pharmacies, Inc. v. Beckwith, 449 U.S. 155 (1980)	12, 13
United Fuel Gas Co. v. Public Serv. Comm'n, 278 U.S. 322 (1929)	8
United States v. General Motors Corp., 323 U.S. 373 (1945)	14

ADMINISTRATIVE DECISIONS

Boston Edison Co., Docket No. 85-266A (Mass. Dep't of Pub. Util. June 26, 1986)	9

TABLE OF AUTHORITIES—Continued

Page

In re Central Vermont Pub. Serv. Corp., 86 P.U.R. 4th 114 (Vt. P.S.C. 1987) 7

CONSTITUTION

U.S. Const., amend. V, cl. 4 ..... *passim*
U.S. Const., amend. XIV, § 1 ..... *passim*

STATUTES

Tex. Rev. Civ. Stat. Ann. art. 1446c, § 35(a) 8

OTHER

Edison Electric Institute, Rate Regulation Department, *Regulatory Treatment of Cancelled Plants: Survey and Analysis of Cases* (1986) 5
C. Phillips, *The Regulation of Public Utilities: Theory and Practice* (1984) 10
Jurisdictional Statement, *Houston Lighting & Power Co. v. Public Util. Comm'n* (filed Aug. 1, 1988) ..... *passim*
U.S. Dep't of Energy, *Energy Security: A Report to the President of the United States* (March 1987) 5, 6, 8

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

No. 88-

HOUSTON LIGHTING & POWER COMPANY,
Appellant,

v.

PUBLIC UTILITY COMMISSION OF TEXAS,
Appellee.

On Appeal from the Supreme Court of Texas

BRIEF OF EDISON ELECTRIC INSTITUTE AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT'S JURISDICTIONAL STATEMENT

Edison Electric Institute ("EEI") submits its brief *amicus curiae* in support of the jurisdictional statement filed by Houston Lighting & Power Company ("HL&P"). Both parties to this appeal have consented to the filing of this brief by EEI.

INTEREST OF THE *AMICUS CURIAE*

EEI is the national association of investor-owned electric utility companies in the United States. Its members supply electric service to consumers throughout the country, serving approximately 97 percent of all customers of the investor-owned segment of the industry and approximately 75 percent of the nation's electric customers.

This case, which involves a decision by the Texas Supreme Court to allocate to ratepayers the tax benefits

relating to costs borne by the utility's shareholders, is of crucial importance to the utilities represented by EEI. With increasing frequency, state utility commissions have been disallowing recovery through rates of part or all of the significant capital costs of utility plant construction. Such disallowances can occur not only when a plant is cancelled, as in the case of HL&P's Allen's Creek Nuclear Project ("Allen's Creek"), but also with respect to a plant that achieves operation, if the state commission decides that some of the costs were imprudently spent.

When such costs are disallowed, commissions often prohibit utilities not only from earning a return *on* their investments, but also from recovering a return *of* the large sums of money invested. In those cases, the only benefits left to investors apart from the relatively small salvage value, if any, are the tax deductions allowable to the company on the loss of its investment. In a case such as this one, where the utility's investment has virtually no salvage value, allocation to the ratepayers of the tax benefits associated with the disallowed costs amounts to a complete confiscation by the state of the utility's property without compensation, in violation of the Fifth and Fourteenth Amendments.

Because of the widespread occurrence of state rate proceedings disallowing costs incurred by utilities to build new plants and the unique position of EEI as the national representative of investor-owned utilities that could be affected by this Court's decision, EEI offers this brief to assist the Court in its understanding of the reasons why probable jurisdiction should be noted. EEI fully endorses all of the arguments presented in HL&P's Jurisdictional Statement. This brief focuses on the fact that the decision of the Texas Public Utility Commission, affirmed by the Texas Supreme Court, resulted in a taking of HL&P's property without compensation in violation of the Fifth and Fourteenth Amendments to the U.S. Constitution.

SUMMARY OF ARGUMENT

This case presents constitutional issues of national importance. In recent years, various factors beyond their control have forced utilities to cancel numerous projects under construction. At the same time, state utility commissions have been increasingly unwilling to allocate to ratepayers all the costs associated with those projects. The large number of cases involving disallowed costs has raised a series of constitutional questions concerning the proper allocation of those costs between ratepayers and shareholders. This Court recently agreed to decide whether a decision of a state supreme court afforded a utility just compensation under the Fifth and Fourteenth Amendments for the dedication of its property to public service. The instant case presents the equally fundamental and important issue of whether the state regulators can use the ratemaking process to take nonutility property without just compensation.

Public utilities have a duty to dedicate their property to provide adequate service to the public. In return, the Constitution guarantees the utilities just compensation for the public use of their property through reasonable rates. When the Texas Public Utility Commission disallowed part of HL&P's investment in the Allen's Creek project, it ruled that the property represented by that investment was nonutility property, not dedicated to public service and not subject to recovery through rates. By allocating to ratepayers the tax benefits associated with the disallowed costs, the state commission took property the commission itself had treated as nonutility property and awarded it to ratepayers in further reduction of their rates. Under settled Fifth Amendment principles established by this Court, the state's action resulted in a confiscation of HL&P's property without just compensation, in violation of the Fifth and Fourteenth Amendments.

The state's action amounted to an unconstitutional taking under all three of the factors this Court traditionally examines: The character of the state's action was extraordinary, both in its reach and unfairness; the economic impact of the state's action on HL&P and, potentially, on the industry, is enormous; and the state's action interfered substantially with the legitimate, investment-backed expectations of HL&P's shareholders. *See, e.g., Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1005 (1984). Where, as here, the state action is not undertaken to protect the public welfare, the taking violates the Fifth Amendment. *See, e.g., Penn Cent. Transp. Co. v. New York City*, 438 U.S. 104, 125 (1978).

THE QUESTIONS PRESENTED ARE SUBSTANTIAL

I. THIS CASE PRESENTS AN ISSUE OF NATIONAL IMPORTANCE.

During the late 1960's, substantial annual growth in the demand for electric power and massive black-outs in the Northeast contributed to a nationwide concern about the dramatic need for increases in utilities' electric power generating capacity. In response, plans abounded for the construction of large, baseload nuclear generating facilities encouraged by federal policy established in the Atomic Energy Act, as well as facilities using other sources of energy. The economic recession of the mid-1970's, however, accompanied by several mild seasons and energy price inflation caused by the OPEC oil embargo, resulted in substantial decreases in the projected demand for additional generating capacity.

Enactment of the Public Utility Regulatory Policies Act and the Power Plant and Industrial Fuel Use Act in 1978, which were a legislative response to the perceived need to diversify fuel use and to encourage alternative sources of electric supply, further changed the regulatory landscape. At the same time, inflation and increasing regulatory requirements resulted in skyrocketing

construction costs and prompted many utilities to reconsider their plans to expand facilities.

The economic pressure to cancel new projects under construction has had widespread effects throughout the electric utility industry. Between 1977 and 1986 alone, at least 94 cancellation cases involving generating facilities of different types were heard in 34 jurisdictions. EEI Rate Regulation Department, *Regulatory Treatment of Cancelled Plants: Survey and Analysis of Cases* 5 (1986) (hereinafter cited as "EEI Survey"). Nuclear power projects like Allen's Creek have encountered particularly crippling problems. Massive changes in regulatory requirements mandated by the Nuclear Regulatory Commission and resulting delays in completion of nuclear plants during a period of rapid inflation and high cost of capital have greatly increased the costs of such plants. Since 1972, 117 nuclear plant orders have been cancelled, and all nuclear plants that were ordered after 1973 have been cancelled. *See* U.S. Dep't of Energy, *Energy Security: A Report to the President of the United States* 189 (March 1987) (hereinafter cited as "DOE Report").

In the current climate, state regulatory commissions have exhibited an inclination against allocating to ratepayers the costs associated with cancelled plants. In 15 of the 94 cases cited above, state regulators decided that the utilities involved would not be entitled to any recovery through rates of the costs invested. EEI Survey at 5. In 67 of those cases, the regulators awarded only partial recovery to the utilities. *Id.* In other cases, even where the new plants had entered service, state regulators frequently have disallowed part of the massive costs invested as imprudently spent.

State regulators' recent unwillingness to grant rate increases necessary to cover the utilities' construction costs has been especially marked where a plant was cancelled

before it ever entered service. As a result, utilities and their investors have been penalized where a *post hoc* review condemned as imprudent investment decisions that appeared sound at the time they were made and approved. On the other hand, when utility investment decisions have proven to be sound, regulators routinely have allocated most of the benefits to the ratepayers. *See* DOE Report at 155.

The plethora of cases involving disallowed costs has raised a series of constitutional questions concerning the proper allocation of those costs between ratepayers and shareholders. Utility managers understandably view the present regulatory environment as a no-win situation that reflects a breakdown in the historic regulatory compact that has existed among utilities, their consumers and investors, and state regulators. *See id.* It has been decades since this Court decided a utility rate case involving the constitutionality of an alleged confiscatory rate order. EEI and its member utilities believe that the balancing of investor and customer interests in ratemaking required by this Court's decisions in *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), and *In re Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), has been ignored in many recent rate decisions. While this Court's agreement to hear argument in *Duquesne Light Co. v. Barasch*, No. 87-1160, *prob. juris. noted*, 108 S. Ct. 1105 (1988), may help to set state regulators back on course, the instant case presents a quite different constitutional issue that raises equally fundamental and important questions about the future of the utility industry.

The important constitutional issue here is whether state regulators can use the ratemaking process to take nonutility property without just compensation. The confiscation of nonutility property approved by the Texas Supreme Court in this case goes far beyond the disputes over which costs may be included in rate base. The

Texas Supreme Court affirmed a decision of the Public Utility Commission to disallow $166 million of the costs of the cancelled Allen's Creek project as imprudently spent; the remainder of the costs were adjudged prudent and recoverable from ratepayers over time. The Commission then allocated to ratepayers *all* of the tax benefits derived from the abandonment of the project—including the estimated $111 million tax benefit attributable to the disallowed costs not paid by ratepayers. The Commission thus awarded to the ratepayers virtually all of the value left in the utility's investment in the plant, even though the ratepayers were not required to bear the cost of that investment.

In denying rate recovery for costs of a cancelled project, state regulators have ruled that the investment represented by those costs was not property dedicated to public service and therefore was not property for which ratepayers were required to pay. The effect of those rulings is that the property represented by the disallowed costs is an investment for which utility investors are solely responsible.

The Texas court went even further, however, and required HL&P's investors to forfeit the remaining value of that investment by allocating to ratepayers *all* of the tax benefits deriving from the investors' loss on the abandoned plant. There has been at least one other case in which state regulators have used this method of penalizing utilities for investments later deemed imprudent. *See In re Central Vermont Pub. Serv. Corp.*, 86 P.U.R.4th 114 (Vt. P.S.C. 1987). These rulings represent a new and totally unjustifiable method for state regulators to impose on utility investors all of the risks and none of the benefits of capital projects and do not bode well for the future.

Industry experts expect that the nation will continue to require substantial amounts of new generating capacity in the years to come. In addition to the normal

increases in demand, existing facilities will grow older, becoming less efficient and less reliable. While the average age of the typical U.S. generating facility was about 15 years in 1985, the average age will be 25 to 30 years in the year 2000. This approaches the typical 30- to 40-year life of most facilities. DOE Report at 148.

If the method used here and in Vermont achieves widespread use, its combination with the recent tendency to exclude investment costs from rate recovery ultimately will severely disadvantage the interests of utility customers as well as the utilities themselves. Rates may be artificially reduced for the short term. However, imposing on investors all project risk—even the risk that investors will forfeit tax benefits ordinarily allowed on an investment's loss—eventually will raise the cost of electricity by hindering utilities' ability to raise much-needed capital for the future at a reasonable cost. The net result of these regulatory policies ultimately will be to endanger the financial stability of the utility industry. *See id.* at 154. The policy issues raised by this case involving the financial health of electric utilities and their ability to accommodate future demand for increased generating capacity thus are of critical national importance.

II. THIS CASE PRESENTS AN IMPORTANT CONSTITUTIONAL ISSUE NOT PREVIOUSLY ADDRESSED BY THIS COURT.

A. This Case Involves a Taking of HL&P's Nonutility Property Not Governed by This Court's Decision in *Hope Natural Gas* and Its Progeny.

Public utilities have a duty to provide adequate service to the public. *United Fuel Gas Co. v. Pub. Serv. Comm'n*, 278 U.S. 322 (1929); *see, e.g.*, Tex. Rev. Civ. Stat. Ann. art. 1446c, § 35(a) (Vernon 1980). Utilities must invest capital to maintain reasonable service and to expand and

upgrade service as necessary to fulfill that duty.[1] *See New York ex rel. New York & Queens Gas Co. v. McCall*, 245 U.S. 345 (1917). Thus, electric companies are required to dedicate their utility property to providing electric service to the public.

The Fifth Amendment guarantees just compensation for private property taken for public use. U.S. Const., amend. V., cl. 4.[2] This Court has held that a utility may not be required to use its property for the benefit of the public without receiving just compensation for the services that the dedicated property renders. *In re Permian Basin Area Rate Cases*, 390 U.S. at 770; *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n*, 262 U.S. 679, 690 (1923). *Accord Board of Pub. Util. Comm'rs v. New York Tel. Co.*, 271 U.S. 23, 31 (1926); *Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 272, 290 (1922) (Brandeis, J., concurring). Utilities receive compensation for the property they dedicate to public use in the form of just and reasonable rates set by state utility commissions.

The state's power to regulate utility rates is premised on the dedication of utility property to public use. *See Munn v. Illinois*, 94 U.S. 113 (1877). The state consequently has no ratemaking power over property belonging to a utility that is not so dedicated. *See Brooks-Scanlon Co. v. Railroad Comm'n*, 251 U.S. 396 (1920). In the

---

[1] Indeed, recent experience shows that utilities may be penalized for not fulfilling that need. *See Boston Edison Co.*, Docket No. 85-266A (Mass. Dep't of Pub. Util. June 26, 1986) (utility that decided not to construct new generating facilities because recent rate orders showed a likelihood much of the investment would be disallowed was penalized for not preparing for future requirements).

[2] The Fifth Amendment's prohibition against governmental takings applies to state action through the Fourteenth Amendment. In addition, the Fourteenth Amendment prohibits state action depriving any person of property without due process of law. U.S. Const., amend. XIV, § 1. The due process issue involved in this case is discussed at length in the Jurisdictional Statement at 20-22.

process of reviewing utility expenditures for capital projects such as Allen's Creek, state regulators decide which costs relate to utility property that serves the public and which relate to nonutility property. Expenditures that relate to utility property are accounted for in state-established rates; expenditures for nonutility property are excluded from rate recovery. C. Phillips, *The Regulation of Public Utilities: Theory and Practice* 195-96 (1984). Excluded costs thus are treated for ratemaking purposes like expenditures for any other property owned by the utility that is not dedicated to public service. In the case at bar, the rate order disallowing certain of the Allen's Creek costs excluded those costs from rate recovery and resulted in treatment of the property to which those costs relate as nonutility property.

The standard of review set by *Hope Natural Gas* and the *Permian Basin Area Rate Cases* determines whether the compensation received by utilities for the value of utility property dedicated to the public is adequate. That standard does not apply here, where the state has appropriated the value of nonutility property and used it to reduce rates payable for the public use of utility property. Because this case involves a taking of nonutility property, rather than the reasonableness of the compensation for the use of utility property, *Hope* and its progeny do not apply, and the case is governed by traditional Fifth Amendment principles.

B. Under Standard Fifth Amendment Principles, the Decision of the Texas Supreme Court Effected a Taking of HL&P's Property Without Compensation.

This Court's recent Fifth Amendment decisions have established no set formula for determining when a compensable taking has occurred, but have engaged in an essentially "ad hoc, factual" inquiry. *Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1005 (1984); *Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1979). That inquiry has examined three primary factors in determining whether

" 'justice and fairness' require that 'economic injuries caused by public action' " must be deemed a compensable taking. *Monsanto Co.*, 467 U.S. at 1005 (quoting *Kaiser Aetna*, 444 U.S. at 175). Those factors are: (i) the character of the governmental action, (ii) the economic impact of the regulation, and (iii) the regulation's interference with reasonable investment-backed expectations. *E.g.*, *Monsanto Co.*, 467 U.S. at 1005; *Kaiser Aetna*, 444 U.S. at 175. The state's confiscation of HL&P's nonutility property in this case is unconstitutional under all three of these factors.

The breadth and unfairness of the state's action in this case were unprecedented. Under the guise of a ratemaking proceeding, state regulators first excluded from rate recovery a large portion of the Allen's Creek costs that the utility reasonably could have expected would be recovered in rates. The regulators then appropriated for the ratepayers virtually all remaining value in the nonutility property that the regulators themselves had excluded from the scope of the proceeding. No police power or other legitimate justification was offered for the appropriation. The additional reduction of rates by the amount of the tax benefit was not a legitimate part of the state's calculation of reasonable rates; rates already had been reduced to take account of the costs with respect to the Allen's Creek project that had been disallowed. By awarding HL&P's nonutility property to ratepayers in further reduction of their rates, the state acted unfairly and far exceeded its authority to regulate utility rates. *See Brooks-Scanlon Co.; Munn.*

Moreover, the state's action violated the Fifth Amendment. A taking of private property without compensation can be justified where public health and safety requires it. *E.g.*, *Penn Cent. Transp. Co. v. New York City*, 438 U.S. 104, 125 (1978). Where, however, no such justification has been offered, the state may not, simply "by *ipse dixit* . . . transform private property into

public property without compensation." *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155, 164 (1980). Where, as here, the state action is a "forced contribution" to the governmental purpose without justification, the state's action violates the Fifth Amendment. *Id.* at 163. *Accord Connolly v. Pension Benefit Guar. Corp.*, 475 U.S. 211 (1986); *Armstrong v. United States*, 364 U.S. 40, 49 (1960).

The economic impact of the decision below is substantial to HL&P and potentially enormous to the industry. The Texas Public Utility Commission itself placed at $111 million the value of the property attributable to the disallowed costs. HL&P calculates that the tax benefit it was required to forfeit with respect to those costs represented virtually the entire value realizable from the disallowed costs. *See* Jurisdictional Statement at 9.

If other states follow Texas' and Vermont's lead, the potential economic effect on the industry as a whole is immense. As discussed above, a large number of rate cases in recent years have involved disallowed costs, and the trend shows no signs of abating. *See supra* at 5-6. In the current climate, state regulators already are using ratemaking proceedings to reduce rates for utility property to what utilities view as a constitutionally impermissible level.[3] If those regulators also are permitted to use their ratemaking authority to take *non-utility* property without compensation in order to reduce rates further, utilities will have few constitutional protections remaining to them. As a result, investors rightly will demand higher returns on equity capital invested in utilities, and the public will face higher electric utility rates.

Finally, the appropriation of HL&P's tax benefits with respect to the Allen's Creek project represents the most

---

[3] EEI hopes that this Court's decision in *Duquesne Light Co.* will restore the constitutional balancing procedure for ratemaking proceedings required by *Hope Natural Gas* and its progeny.

fundamental interference with legitimate, investment-backed expectations of utility shareholders. Investors in HL&P took the risk that the utility's capital projects might be cancelled and that, in the currently changing regulatory climate, investors might be denied full recovery of their investment, as well as a reasonable return thereon. However, investors in HL&P did *not* take the risk that the tax deductions ordinarily available to investors who suffer a loss would be appropriated by the state and awarded to ratepayers in further reduction of their rates.

The expectation defeated by the challenged regulatory action is far more than merely a " 'unilateral expectation or an abstract need.' " *Monsanto Co.*, 467 U.S. at 1005 (quoting *Webb's Fabulous Pharmacies*, 449 U.S. at 161). It is a right established by federal statute in section 165 of the Internal Revenue Code. *See generally Monsanto Co.* (property interest established by an independent source of law is protected by Fifth Amendment). The interference by Texas regulators with this eminently reasonable investment-backed expectation alone should be sufficient to constitute a compensable taking under this Court's decisions. *See id.* at 1005 (interference with reasonable investment-backed expectations so overwhelming as to enable Court to decide on that ground alone that a taking had occurred). *Accord Hodel v. Irving*, 107 S. Ct. 2076 (1987) (character of governmental action alone sufficient to enable court to hold there was a taking).

As discussed in the Jurisdictional Statement, the appropriation of all of HL&P's tax benefits rendered the Allen's Creek nonutility property essentially worthless since the property had little salvage value. *See* Jurisdictional Statement at 9. State action not undertaken on the grounds of protecting the public welfare that leaves private property with essentially no material value effects a taking for which compensation to the owner is due. *See, e.g., Irving*, 107 S. Ct. at 2084. Since it is the

" 'deprivation of the former owner rather than the accretion of a right or interest to the sovereign' " that constitutes a taking, *Monsanto Co.*, 467 U.S. at 1004-1005 (quoting *United States v. General Motors Corp.*, 323 U.S. 373, 378 (1945)), it is clear that the state's appropriation of virtually all the value remaining to investors in the nonutility property constitutes a compensable taking.

CONCLUSION

This case presents constitutional issues of national importance. Neither the Court's existing precedents in *Hope Natural Gas* and its progeny, nor *Duquesne Light Co.*, in which this Court has noted probable jurisdiction, can resolve the issues presented here. For these reasons, the Court should note probable jurisdiction and set this case for oral argument.

Respectfully submitted,

JAN J. SAGETT *
PETER B. KELSEY
WILLIAM L. FANG
EDISON ELECTRIC INSTITUTE
1111 19th Street, N.W.
Washington, D.C. 20036
(202) 778-6616
Attorneys for
Edison Electric Institute

August 1, 1988

* Counsel of Record

(4)

88-181

Supreme Court, U.S.
FILED
AUG 1 1988
JOSEPH F. SPANIOL, JR.
CLERK

NO. _____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

HOUSTON LIGHTING & POWER COMPANY,
Appellant

v.

PUBLIC UTILITY COMMISSION OF TEXAS,
Appellee

On Appeal From The Supreme Court of Texas

AMICUS CURIAE BRIEF OF ARTHUR ANDERSEN & CO. IN SUPPORT OF THE APPEAL OF HOUSTON LIGHTING & POWER COMPANY

DAVID C. DUGGINS
CLARK, THOMAS, WINTERS
& NEWTON
P. O. Box 1148
Austin, Texas 78767

Attorney for
Arthur Andersen & Co.

Alpha Law Brief Co., Inc. — 8748 Westpark—Houston, Texas 77063 — 789-2000

TABLE OF CONTENTS

	Page
INTEREST OF AMICUS CURIAE	1
SUMMARY OF ARGUMENT	2
ARGUMENT AND AUTHORITIES	3
I. CHARACTERISTICS OF PROPERTY	3
Generally Accepted Accounting Principles	3
Applicable Law	5
II. PROPERTY AND EXPENSE EXCLUDED FROM RATES IS NON-UTILITY	5
III. TAX BENEFITS FOLLOW THE ASSET OR EXPENSE	6
Preponderant Regulatory Practice	6
Uniform System of Accounts	10
IV. THE TEXAS SUPREME COURT RELIED ON OBSOLETE PRECEDENTS	11
V. PROBABLE VIOLATION OF INTERNAL REVENUE CODE AND REGULATIONS	14
CONCLUSION	16
PROOF OF SERVICE	18

INDEX OF AUTHORITIES

CASES	Page
Cascade Natural Gas Corporation v. El Paso Natural Gas Company, 386 U.S. 169 (1967)	5
City of Charlottesville v. F.E.R.C., 774 F.2d 1205 (D.C. Cir. 1985), *cert. denied*, 106 S. Ct. 1515 (1986)	14
Federal Power Comm'n v. United Gas Pipe Line Co., 386 U.S. 237 (1967)	11, 12, 13
Florida Gas Transmission Company, 93 P.U.R. 3d 477 (1972)	13
Matter of Procedures for Implementing the Detariffing of Customer Premises Equipment and Enhanced Services (Second Computer Inquiry), F.C.C. Docket No. 83-551 (November 23, 1983)	9
Public Systems v. F.E.R.C., 709 F.2d 73 (D.C. Cir. 1983)	8
Re Income Tax Expense for Ratemaking Purposes, 59 P.U.R. 4th 576 (1984)	9
Re Southwestern Bell Application to Increase Rates, P.U.C. Docket 5220 (May 19, 1984)	10
Southern California Edison Co., 23 P.U.R. 4th 44 (1977)	14
United States v. Western Electric Co., Inc., No. 82-0192 (D. Dist. Col., December 16, 1982)	9

UNITED STATES STATUTES	
26 U.S.C.A. § 167(e) (Supp. 1988)	12
26 U.S.C.A. § 168(i)(9) (Supp. 1988)	12

CODE OF FEDERAL REGULATIONS	
18 C.F.R. 101 (1987)	6, 10

TEXAS ADMINISTRATIVE CODE	
16 Tex. Admin. Code § 23.12(a)(2)(B)(i) (1986)	6
16 Tex. Admin. Code § 23.21(b)(1)(D) (1986)	8

NO. _____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

HOUSTON LIGHTING & POWER COMPANY,
Appellant

v.

PUBLIC UTILITY COMMISSION OF TEXAS,
Appellee

On Appeal From The Supreme Court of Texas

AMICUS CURIAE BRIEF OF ARTHUR ANDERSEN & CO. IN SUPPORT OF THE APPEAL OF HOUSTON LIGHTING & POWER COMPANY

Arthur Andersen & Co. respectfully submits its Amicus Curiae brief in support of Appellant's appeal. Written consent of all parties to the filing of this brief has been obtained.

INTEREST OF AMICUS CURIAE

Arthur Andersen & Co. is one of the largest international independent public accounting firms with 226

offices located in 49 countries throughout the world, of which 80 are in the United States and 5 in Texas. Arthur Andersen audits approximately one-third of the electric and gas companies in the United States and a substantial portion of the telephone industry. As independent public accountants, Arthur Andersen believes that proper reporting to the public of financial information, including the effects of income taxes, is extremely important because of the potential effect on investment decisions. With respect to public utility companies, the reported financial information is affected to a significant degree by the ratemaking procedures applied to such utilities by regulatory commissions. Therefore, Arthur Andersen is vitally concerned about the matter before this Court.

Arthur Andersen & Co. urges the Court to note jurisdiction in order to review the decision of the Supreme Court of Texas that federal income tax savings related to expenses not included in cost of service should be used to reduce cost of service. Such tax savings are shareholder property and should not be used to reduce regulated cost of service. Review and reversal of the Texas court's action is necessary to avoid confiscation of shareholder property, violation of fundamental accounting principles, and a probable violation of the Internal Revenue Code.

SUMMARY OF ARGUMENT

The ability to reduce taxes is one of the characteristics of property. This Court recognizes that the ability to reduce taxes has value. Generally accepted accounting principles recognize the value of and asset characteristics of tax benefits.

Simple fairness dictates that tax benefits follow the asset or expense which gave rise to the benefits. This proper allocation is the preponderant regulatory practice, and is consistent with generally accepted accounting principles and the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission (FERC) and adopted by the Public Utility Commission of Texas ("Texas Commission"). The precedent upon which the Texas Supreme Court relied, principally the *United Gas* decision of this Court, is obsolete due to accounting, regulatory, and legal changes subsequent to that decision.

In this case, the expense, $166,000,000 in abandonment cost, which gave rise to the tax benefit was disallowed from rates by the Commission and thus borne by the shareholders. The tax benefit derived from that expense has value and belongs to the shareholder. The Texas Supreme Court's decision to give this asset, the tax benefit, to the ratepayers confiscates shareholder property and, in all likelihood, violates the normalization provisions of the Internal Revenue Code.

ARGUMENT AND AUTHORITIES

I.

CHARACTERISTICS OF PROPERTY

Generally Accepted Accounting Principles

Property has two inherent characteristics. One is the ability of an asset to generate revenues and the second is the ability of the asset to reduce income taxes. Statement of Fnancial Accounting Concepts No. 6, issued December 1985 by the Financial Accounting Standards

Board (FASB),[1] refers to these characteristics as "service potential" or "future economic benefit".

The Accounting Principles Board, predecessor board to the FASB, and the FASB discussed the value associated with the reduction in taxes in pronouncements affecting the accounting for business combinations. Accounting Principles Board (APB) Opinion No. 16 (issued August 1970) states:

> Estimated future tax effects of differences between the tax bases and amounts otherwise appropriate to assign to an asset or liability are one of the variables in estimating fair value. Amounts assigned to identifiable assets and liabilities shall, for example, recognize that the fair value of an asset to an acquirer is less than its market or appraisal value if all or a portion of the market or appraisal value is not deductible for income taxes.

Additionally, Statement of Financial Accounting Standards (SFAS) No. 38, (issued September 1980), paragraph 5, provides the accounting for the potential tax benefit of a loss carryforward of a purchased subsidiary. If the utilization of the tax benefits is assured beyond any reasonable doubt, this pronouncement provides for the tax loss carryforward to be recorded as an asset.

Statement of Financial Accounting Standard No. 96 (issued December 1987) modified the accounting for tax

---

1. The Financial Accounting Standards Board was established in 1973 as the successor board to the Accounting Principles Board. This board is the authoritative body with regard to accounting principles. The Securities and Exchange Commission in Accounting Series Release No. 150 dated December 20, 1973 reaffirmed that the FASB will be considered to be substantial authoritative support and accounting practices contrary to FASB pronouncements will be considered to have no such support.

benefits related to purchases described in APB Opinion No. 16 and SFAS No. 38, but continued to acknowledge that the tax benefits did affect the value of an asset and that tax benefits have some of the characteristics of assets.

Applicable Law

This Court has recognized that ability to reduce taxes is an asset. In *Cascade Natural Gas Corporation v. El Paso Natural Gas Company*, 386 U.S. 169 (1967), the Court found that the pre-merger tax losses of Pacific Northwest (the company acquired and then spun off) which were used by El Paso Natural Gas Company (the acquirer) after the merger but prior to spin-off were of value and required remuneration. It was argued that the tax loss carryovers were in a real sense an asset of Pacific Northwest, the new company, and it should receive other assets or a reduction in debt of an equivalent value. The Court found that "these allegations, if proven, require remuneration of some kind to the new company." Based on the *Cascade* case, Houston Lighting & Power's tax deductions associated with abandonment of Allen's Creek are clearly an asset of which the company may not be deprived without compensation.

II.

PROPERTY AND EXPENSE EXCLUDED FROM RATES IS NON-UTILITY

Houston Lighting & Power Co. commenced planning work in the early 1970's for the construction of Allen's Creek Nuclear Station. In 1982, the company decided to abandon the Allen's Creek project. Thus,

Allen's Creek would never be used in rendering electric utility service as a utility plant. Allen's Creek costs could only be utility property to the extent allowed by the Texas Commission. The Uniform System of Accounts of the FERC, 18 C.F.R. 101 (1987), which has been adopted by the Texas Commission, 16 Tex. Admin. Code § 23.12(a)(2)(B)(i) (1986), recognizes that a commission may allow recovery of abandonment costs. Account 407, "Amortization of Property Losses, Unrecovered Plant, and Regulatory Study Costs" allows for costs to be charged to this utility account " . . . when the Commission has authorized the amount . . ." of unrecovered Plant and Regulatory Study Costs " . . . to be amortized by charges to electric operations." The non-utility nature of abandonment costs not allowed to be recovered through rates is provided for in account 426.5, "Other Deductions" which provides "this account shall include other miscellaneous expenses which are non-operating in nature. . . ." Items included in the account 426.5 description include abandonments not allowed to be written off to account 407. The Allen's Creek abandonment costs are utility costs only to the extent allowed by the Texas Commission. The amounts disallowed by the Texas Commission are non-utility costs and the responsibility of the shareholder.

III.

TAX BENEFITS FOLLOW THE ASSET OR EXPENSE

Preponderant Regulatory Practice

Under the standard ratemaking practice in Texas and all other regulatory jurisdictions in the United States,

revenue requirements are set to allow a public utility the opportunity to recover all of its costs, including income taxes, plus a return on its unrecovered investment in public utility property. If a cost is disallowed for ratemaking purposes, one would expect that the effect of the disallowance would be to leave revenue requirements at the same amount as if the disallowed cost had not been incurred. To illustrate, (1) assume that operating expenses, including depreciation and taxes, of a utility are $30,000,000. This amount would be included in revenue requirements collectible from ratepayers. (2) Assume further that $1,000,000 of additional expenses are incurred and allowed for ratemaking purposes. Revenue requirements would increase by $1,000,000, to $31,000,000. (Since both taxable revenues and tax-deductible expenses would increase by $1,000,000, these would have no effect on taxable income or income tax expense.) (3) Assume further that the regulator disallows the $1,000,000 of expenses for ratemaking purposes. It would be expected that the revenue requirements related to operating expenses would remain at $30,000,000. However, the action of the Texas Commission, as upheld by the Supreme Court of Texas, would reduce operating expenses in the revenue requirements to approximately $29,148,000 (at the 46% Federal Income Tax rate then in effect) because the tax benefit of the $1,000,000 was given to the ratepayer without the burden of the associated expense. As a result, ratepayers would receive a windfall and the utility would recover less than the $30,000,000 of its allowed operating expenses, thereby confiscating shareholder property. In the case at bar, the windfall was $111,000,000.

The preponderant practice of federal and state regulatory commissions, including the FERC and the Texas Commission, is greatly at odds with the decision of the Texas Commission upheld by the Texas Supreme Court in this case. The prevailing practice of these agencies is to require that tax expense (both positive and negative) be "synchronized" or "normalized" by allocating the expense between operating expenses allowed for ratemaking purposes and those disallowed for ratemaking purposes.

Both FERC and the Texas Commission have recognized that tax recovery should be allowed on an allocated (normalized) basis. The Texas Commission's Substantive Rule 23.21 (b)(1)(D), 16 Tex. Admin. Code § 23.21(b)(1)(D) (1986), allows, as a component of the cost of service, "Federal income taxes on a normalized basis." The FERC in Order 144, 46 Fed. Reg. 26613 (May 1981), concluded that "tax normalization more appropriately comports with sound regulatory principle and with the public interest. . . ." In Order 144, page 22, the FERC states that "The central rationale for tax normalization is that tax normalization matches the recognition in rates of the tax effects of the costs and revenues to the recovery in rates of the associated costs and revenues themselves." FERC succinctly stated the point of taxes following the expenses on page 37 of Order 144: "Tax normalization synchronizes the recognition in rates of the expense itself." Order 144 was affirmed in *Public Systems v. F.E.R.C.*, 709 F.2d 73 (D.C. Cir. 1983).

The Supreme Court of Texas has upheld a reduction of incurred income tax expense *applicable* to Utility Operations through use of income tax deductions *not applicable* to Utility Operations. This is clearly contrary to the required synchronization of tax normalization as prescribed by both the FERC and the Texas Commission.

Discussing regulatory allocation of tax expense, the California Public Utilities Commission stated:

> The Commission has consistently calculated income taxes for ratemaking purposes based on the cost of service developed from adopted expenses, which excludes the various disallowed expenses. This method results in adopted income taxes higher than otherwise, because the disallowed expenses are not included as tax deductions. Both the staff and the Industry recommend that the present practice continue. . . . We agree with staff and Industry that the present method of treating these costs is reasonable and should be continued. . . .

Re Income Tax Expense for Ratemaking Purposes, 59 P.U.R. 4th 576, 582-83 (1984).

This preponderant regulatory practice of tax effects following the asset is also clearly demonstrated in the divestiture of American Telephone and Telegraph (AT&T). Customer Premise Equipment (CPE) was transferred to unregulated AT&T from the regulated regional Bell holding companies. The Federal Communication Commission (FCC) determined that, to comply with the plan of reorganization, *see United States v. Western Electric Co., Inc.*, No. 82-0192 (D. Dist. Col., December 16, 1982). it was appropriate for the accumulated deferred taxes and investment tax credits associated with the CPE be transferred to AT&T and be unregulated. *Matter of Procedures for Implementing the Detariffing of Customer Premises Equipment and Enhanced Services (Second Computer Inquiry),* F.C.C. Docket No. 83-551 (November 23, 1983).

The Texas Commission agreed with the FCC and in its Docket No. 5220 allowed the CPE and related de-

ferred taxes and investment tax credits to be transferred from Southwestern Bell Telephone Company to AT&T. *Re Southwestern Bell Application to Increase Rates*, P.U.C. Docket 5220 (May 19, 1984).

Uniform System of Accounts

The regulator must determine what revenues and expenses (including incurred income tax expense) are applicable to utility operations of the regulated entity. When the regulator sets rates for an entity based on less than all of its revenues and expenses, the related income tax expense must also be allocated between regulated utility operations and other activities. This allocation recognizes that the tax effects should be matched with the related expense or income giving rise to the taxes. The method for determining this allocation is set forth in the Uniform System of Accounts. 18 C.F.R. 101 (1987). Separate accounts are provided for income taxes related to "utility operating income" (Accounts 409.1, 410.1, 411.1) and "other income and deductions" (Accounts 409.2, 410.2, 411.2). Utility operating income refers to revenues and expenses allowed for ratemaking purposes; other income and deductions refers to revenues and expenses disallowed or considered nonregulated for ratemaking purposes.

The instructions for these accounts state that the ". . . accruals for income taxes shall be apportioned among utility departments and to Other Income and Deductions so that, as nearly as practicable, each tax shall be included in the expenses of the utility department or Other Income and Deductions, the income from which gave rise to the tax." The instructions for account 409.1, Income Taxes, Utility Operating Income, state that this

". . . account shall be maintained so as to allow ready identification of tax effects (both positive and negative) relating to Utility Operating Income . . ." The instructions for account 409.2, Income Taxes, Other Income and Deductions, state that this ". . . account shall include the amount of . . . income taxes (both positive and negative), which relate to Other Income and Deductions." Since the Allen's Creek costs disallowed by the Texas Commission are reported as Other Deductions, the tax consequences of those costs should be reported in account 409.2.

However, the Supreme Court of Texas's decision would effectively require the taxes applicable to the disallowed expenses to be reported as a negative component of Income Taxes, Utility Operating Income. This is a clear violation of the Public Utility Commission's own rules, as well as the Uniform System of Accounts adopted by those rules.

IV.

THE TEXAS SUPREME COURT RELIED ON OBSOLETE PRECEDENTS

The Supreme Court of Texas, in reaching its decision, relied on this Court's decision in *Federal Power Comm'n v. United Gas Pipe Line Co.*, 386 U.S. 237 (1967). In that case, this Court allowed the Federal Power Commission (FPC) to offset the taxable losses of unregulated affiliates, to the extent that the losses exceed taxable income of unregulated affiliates, against utility taxable income for determining income tax expense for rate purposes, in effect passing on the tax benefits of losses of unregulated affiliates to ratepayers. This Court did not rule that this approach was the only approprate

methodology, but found merely that the FPC's method of allocating taxes "did not exceed the powers granted to it by Congress." *Id.* at 243. Neither the confiscation question at issue here nor any other constitutional question was raised or decided in *United.*

Subsequent to the *United* decision of 1967, however, a number of events have occurred with respect to using the tax benefits of expenses not included in cost of service for purposes of reducing the taxes included in cost of service which render the tax treatment in the *United* decision obsolete.

1. In December, 1967, the American Institute of Certified Public Accountants (AICPA) Accounting Principles Board adopted Opinion No. 11 which prescribed the normalization method of income tax accounting.

2. In 1969, Congress became concerned that tax reductions created by the use of accelerated tax depreciation instead of straight-line depreciation were being flowed-through to ratepayers immediately. Such flow-through reduced Treasury revenues and was contrary to the Congressional intent manifested in its enactment of accelerated depreciation in 1954. The intent of accelerated depreciation was to encourage the modernization of the nation's productive facilities by reducing the cost of financing new additions, not to achieve an immediate decrease in utility rates. To achieve its intent, Congress revised the Internal Revenue Code in 1969, which provisions were strengthened in 1971, 1981, 1982 and 1986, to state that a public utility company cannot use accelerated tax depreciation unless the utility is subject to the normalization method for ratemaking purposes. 26 U.S.C.A. §§ 167(e), 168(i)(9) (Supp. 1988) [formerly 168(e)(3)]. The normalization method requires that in-

come tax expense allowed for ratemaking purposes be "matched" to depreciation expense allowed for ratemaking purposes. The Texas Supreme Court in this case violated the matching inherent in normalization by permitting the Commission to compute allowed income tax expense for ratemaking purposes by the use of deductions generated by expenses which were disallowed for ratemaking purposes. There is a distinct possibility, discussed *infra,* that this violation of the normalization rules will result in Appellant being ruled ineligible for accelerated depreciation by the Internal Revenue Service (IRS), with immediate adverse effect on its stockholders and ratepayers.

3. The FPC, in 1969, amended its Uniform System of Accounts to require that income taxes (both positive and negative) applicable to non-regulated or other "below the line" costs should be allocated "below the line." Order 389, 34 Fed. Reg. 17436 (October 1969).

4. The FPC, in 1972, adopted a tax allocation method contrary to the method it used in the *United* case. In *Florida Gas Transmission Company,* 93 P.U.R. 3d 477, 496 (1972), the FPC stated:

> In our opinion a utility should be regulated on the basis of its being an independent entity; that is a utility should be considered as nearly as possible on its own merits and not on those of its affiliates.

5. The FPC, in 1977, continued the tax allocation method used in *Florida Gas,* and specifically referred to its earlier *United* decision:

> In the *United* case the commission had proceeded on the thesis that "tax losses" from nonjurisdic-

> tional activities of a company are to be considered in fixing the income tax allowance for jurisdictional activities. This approach was subjected to reevaluation in Florida Gas, and, as an alternate ground for decision in that case, the commission determined that utilities should henceforth be considered as separate entities for the ratemaking purpose of determining their costs of providing jurisdictional service. . . . Consequently, cities' reliance upon Cities Service and United is misplaced, the rationale underlying those decisions being no longer persuasive for ratemaking purposes. . . . [I]t would be difficult to justify the appropriation of any tax savings . . . by the jurisdictional consumers when these same consumers did not pay the expenses which created the deductions for tax purposes.

Southern California Edison Co., 23 P.U.R. 4th 44 (1977).

6. More recently, the U.S. Court of Appeals, D.C. Circuit, upheld the FERC's continued application of separate entity, stand alone ratemaking methodology. *City of Charlottesville v. F.E.R.C.*, 774 F.2d 1205 (D.C. Cir. 1985), *cert. denied,* 106 S. Ct. 1515 (1986).

Changes and events subsequent to the *United* case have rendered the FPC's tax treatment in that decision obsolete. Accordingly, the Texas Supreme Court's reliance on that case as authority for its decision is unjustified.

V.

PROBABLE VIOLATION OF INTERNAL REVENUE CODE AND REGULATIONS

As stated earlier, Congress has set limitations on the right of public utility companies to deduct accelerated tax depreciation where rate regulation was inconsistent with the "normalization" method.

Based on the Internal Revenue Code and related Regulations, it is probable that the Texas Commission's reduction in income tax expense in cost of service reflecting the tax benefit from disallowed expenses would be held by the IRS to constitute a violation. This is because income tax expense in cost of service would be less than required by the IRS rules for normalization. Based on several private letter rulings from the IRS,[2] it is quite clear that it is a violation to use tax losses from unregulated activities to reduce regulated cost of service. (The disallowance of part of the cost of Allen's Creek project has the effect of passing such disallowed costs to the Company's shareholders, thus effectively removing such costs from regulation.)

For example, in Private Letter Ruling No. 86-43052, issued July 29, 1986, the IRS concluded that a taxpayer will not be in compliance with the normalization requirements if, in computing its income tax expense for ratemaking purposes, such tax expense is reduced by the tax effects attributable to the income tax losses of other entities. The IRS stated:

> . . . the use of tax benefits attributable to other entities in the determination of deferred tax expense or current tax expense will cause Taxpayer to fail to comply with the normalization provisions of the Code and the regulations thereunder. . . . Taxpayer will not be in compliance with the normalization requirements of Sections 167(1) and 168(e)(3) of the Code, if, in computing its total expense for purposes of establishing its cost of service for rate-

2. For example, PLR 86-43052, 87-11050, 88-01041. Even though private letter rulings are technically directed to the taxpayer requesting the ruling, they reflect the thinking of the IRS on any given issue.

making purposes, its current tax expense is reduced by a portion of the tax savings attributable to the tax losses of Loss Subsidiaries.

The IRS also ruled that consistency is required with respect to assumptions used in calculating income tax expense, depreciation expense, deferred taxes, and rate base. The IRS noted that, in the above-cited situation, the losses of the subsidiaries are being used to calculate income tax expense; however, none of the loss entities' assets are included in rate base and the depreciation of the loss entities' assets is not being considered in calculating the taxpayer's depreciation expense. A lack of consistency would also cause a normalization violation to occur.

The loss of accelerated tax deductions resulting from this violation would severely reduce cash flow to the utility through the elimination of the cost-free capital provided by this tax incentive. The necessary replacement capital would greatly increase the revenue requirements which must be collected from future ratepayers.

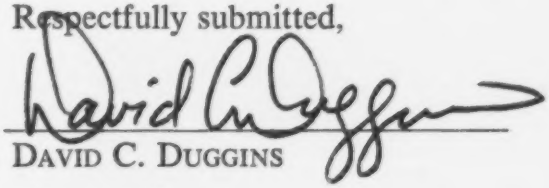
CONCLUSION

From an accounting standpoint, the Texas Supreme Court's decision on the tax issue herein discussed is simply wrong. Since the accounting fundamentals which are violated by the Texas Supreme Court's decision are part of the substantive rules of the Texas Commission, the decision is wrong from a legal standpoint. From the standpoint of simple fairness, it appears to *amicus* that, assuming an expense to be imprudent, the regulatory goal should be to place ratepayers in the same position they would have held had the expense never been incurred.

By both disallowing the expense and crediting ratepayers with the tax savings generated by the expense, the Texas Supreme Court decision places ratepayers in a better position than they would have been had the expense never occurred, since a nonexistent expense would obviously not generate a tax savings.

The Texas Supreme Court's decision upholds penalizing the utility's equity owners, confiscates shareholders' assets, and grants a windfall to its ratepayers. This windfall will be short-lived, however, since the decision will probably result in Appellant's loss of the benefits of accelerated tax depreciation, thereby inevitably increasing rates. The decision is justified by neither principles of accounting, the applicable law, nor by simple fairness. This Court should note jurisdiction and reverse, to correct the improper treatment and resulting confiscation of shareholder tax benefits.

Respectfully submitted,



DAVID C. DUGGINS

Attorney for
Arthur Andersen & Co.

Of Counsel:

CLARK, THOMAS, WINTERS & NEWTON
P. O. Box 1148
Austin, Texas 78767

PROOF OF SERVICE

I, David C. Duggins, Attorney for Arthur Andersen & Co., Amicus Curiae herein, and a member of the Bar of the Supreme Court of the United States, hereby certify that on the 29 day of July, 1988, I served copies of the foregoing Amicus Curiae Brief of Arthur Andersen & Co. on the parties hereto, said copies being mailed to:

Karen Pettigrew
Assistant Attorney General
ATTORNEY GENERAL'S OFFICE
14th and Colorado, SCB
P. O. Box 12548, Capitol Station
Austin, TX 78711-2548
Attorney for Appellee

Edgar M. Roach, Jr.
HUNTON & WILLIAMS
One Hannover Square
Raleigh, NC 27602
Attorney for Appellants

David C. Duggins

DAVID C. DUGGINS

(5)

88-181

No. 88-

Supreme Court, U.S.
FILED
AUG 1 1988
JOSEPH F. SPANIOL, JR.
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

HOUSTON LIGHTING & POWER COMPANY,

Appellant,

v.

PUBLIC UTILITY COMMISSION OF TEXAS,

Appellee.

On Appeal From The Supreme Court Of Texas

BRIEF OF GULF STATES UTILITIES COMPANY AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT

Raymond F. Dacek*
Floyd L. Norton, IV
David E. Jacobson
Michael D. Paul
Reid & Priest
1111 - 19th Street, N.W.
Washington, D.C. 20036
(202) 828-0100

Attorneys for
Gulf States Utilities Company

* *Counsel of Record*

August 1, 1988

PRESS OF BYRON S. ADAMS, WASHINGTON, D.C. (202) 347-8203

QUESTIONS PRESENTED

Gulf States Utilities Company adopts the questions presented as set forth in the brief of appellant Houston Lighting & Power Company.

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED	i
TABLE OF AUTHORITIES	iii
INTEREST OF *Amicus Curiae*	2
STATEMENT OF THE CASE	3
ARGUMENT	4
I. THE DECISION OF THE SUPREME COURT OF TEXAS, REQUIRING HOUSTON TO REDUCE ITS RATES BY THE AMOUNT OF TAX BENEFITS RELATED TO ITS DISALLOWED COSTS, CONSTITUTES A TAKING WITHOUT COMPENSATION	4
A. The Tax Benefits Associated With the Disallowed ACNP Costs Should Inure to the Benefit of Houston's Shareholders	5
B. The PUC Confiscated Property From Houston's Shareholders Without Compensation	6
C. Frustration of Reasonable Investment-Backed Expectations Also Constitutes an Unconstitutional Taking	9
II. THE COURT'S DECISION IN FPC v. HOPE NATURAL GAS COMPANY DOES NOT JUSTIFY THE ACTION OF THE PUC AND THE SUPREME COURT OF TEXAS	11
CONCLUSION	12

TABLE OF AUTHORITIES

CASES:	Page
Brooks-Scanlon Company v. Railroad Commission of Louisiana, 251 U.S. 396 (1920)	9
City of Charlottesville, Virginia v. FERC, 774 F.2d 1205 (D.C. Cir. 1985), *cert. denied*, ___U.S. ___, 106 S.Ct. 1515 (1986)	6,8
El Paso Electric v. FERC, 667 F.2d 462 (5th Cir. 1983)	5
Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591 (1944)	11,12
Kaiser Aetna v. United States., 444 U.S. 164 (1979)	10
Northern Pacific Railway Company v. North Dakota, 236 U.S. 585 (1915)	5
Pennsylvania Coal Company v. Mahon, 260 U.S. 393 (1922)	10
Public Utility Commission of Texas v. Houston Lighting & Power Company, 748 S.W.2d 439 (Tex. 1987)	1,6,8,9,13
Public Utility Commission of Texas v. Houston Lighting & Power Company, No. C-5705, On Motion for Rehearing, slip op. (Tex. May 4, 1988)	3
Ruckelshaus v. Monsanto, 467 U.S. 986 (1984)	9,10,11
Suburban Utility Corporation v. Public Utility Commission of Texas, 652 S.W.2d 358 (Tex. 1983)	5
Tennessee Gas Pipeline v. FERC, 606 F.2d 1094 (D.C. Cir. 1979), *cert. denied*, 445 U.S. 920 (1980)	5
United States v. General Motors Corporation, 323 U.S. 373 (1945)	10

Table of Authorities Continued

	Page
ADMINISTRATIVE DECISION:	
Columbia Gulf Transmission Company, 23 FERC (CCH) ¶ 61,396 (1973)	5
CONSTITUTION, STATUTES AND REGULATIONS:	
U.S. Const. Amend. V	4,9,11
U.S. Const. Amend. XIV	4,9,11
Section 39, Public Utility Regulatory Act, Art. 1445c, Tex. Rev. Stat	5
MISCELLANEOUS:	
A.J.G. Priest, *Principles of Public Utility Rate-making* 45 (1969)	5

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

HOUSTON LIGHTING & POWER COMPANY,
Appellant,

v.

PUBLIC UTILITY COMMISSION OF TEXAS,
Appellee.

On Appeal From The Supreme Court Of Texas

BRIEF OF GULF STATES UTILITIES COMPANY AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT

Gulf States Utilities Company ("GSU" or "Company"), in accordance with Supreme Court Rule 36.1, respectfully submits its brief *amicus curiae* in support of the appeal filed by Houston Lighting & Power Company ("Houston") to review the decision of the Supreme Court of Texas of December 16, 1987, in *Public Utility Commission of Texas v. Houston Lighting & Power Company*, 748 S.W.2d 439 (Tex. 1987) ("*Houston*").[1]

---

[1] GSU has obtained written consents of both parties to this case. The written consents have been filed with the Clerk of this Court.

INTEREST OF AMICUS CURIAE

GSU filed a brief *amicus curiae* in support of Houston's Motion for Rehearing before the Texas Supreme Court. The Company provides electric service to 555,000 customers in an area extending from Baton Rouge, Louisiana, to a point some fifty miles east of Austin, Texas. GSU is regulated by the Public Utility Commission of Texas ("PUC") as well as the Louisiana Public Service Commission and, at wholesale, by the Federal Energy Regulatory Commission.

In GSU's last rate proceeding before the PUC, certain costs were excluded from rate base and "held in abeyance" pending further review. In addition, other GSU costs were disallowed as imprudent. Finally, there are other non-utility operating expenses which the Company does not recover in rates. The tax benefits arising from the costs held in abeyance and disallowed, as well as the benefits arising from other "below-the-line" costs were accorded treatment similar to that ordered by the PUC and affirmed by the Texas Supreme Court in its Opinion and Judgment of December 16, 1987. The current tax benefits associated with the deductions relating to the costs held in abeyance, disallowed, or otherwise below-the-line and not recognized in rates were credited to ratepayers. The PUC's appropriation to ratepayers of tax benefits stemming from such below-the-line costs not recognized in the Company's rates, as applied to GSU, will seriously impact GSU's financial integrity. GSU is already on the brink of insolvency; indeed, the PUC's tax decision alone will result in lowering GSU's revenue requirement by about $30 million per year.

STATEMENT OF THE CASE

In 1972, Houston initiated plans to construct the Allen's Creek Nuclear Project ("ACNP"), a two-unit, 2400-megawatt plant. In 1976, Houston announced a modification to this plan, deciding instead to build only one of the 1200-megawatt units. Over the next few years, several events occurred which resulted in Houston's cancelling ACNP on August 26, 1982. This cancellation resulted in a loss of approximately $361 million. In 1982, Houston filed with the PUC an application for a rate increase which included as a cost the amortization to ratepayers of the ACNP expenditures.

The PUC determined that ACNP should have been cancelled on January 1, 1980, and that all costs relating to ACNP from that date until its cancellation in August 1982 were imprudent. The "imprudent" expenditure, totalling approximately $166 million, was disallowed and not recoverable from Houston's ratepayers. The PUC, changing its standard procedure (*see Public Utility Commission of Texas v. Houston Lighting & Power Company*, No. C-5705, On Motion for Rehearing, slip op. at 2 (Tex. May 4, 1988) (Wallace, dissenting)), also required Houston to provide its ratepayers the tax benefits associated with this loss, in the amount of $111 million.

The decision of the PUC was reversed by the trial court, and the trial court's decision was affirmed by the court of appeals. On appeal, the Texas Supreme Court reversed the lower courts and affirmed the PUC. The Opinion of the Texas Supreme Court gives the PUC discretion to appropriate for the ratepayer the tax benefits arising from disallowed or other below-the-line costs.

Having disallowed the $166 million cost and excluded it from Houston's utility cost of service, the PUC should have excluded the associated tax effects from cost of service as well. The tax effects of the loss would then inure to Houston's shareholders, not its ratepayers. Instead, the PUC purportedly exercising its discretion, with the Texas Supreme Court affirming, appropriated the tax benefits associated with these disallowed costs, in violation of the Fifth Amendment of the United States Constitution as applied to the States through the Due Process Clause of the Fourteenth Amendment.

Gulf States Utilities Company respectfully requests this Court to grant Houston's appeal and reverse the Opinion and Judgment rendered by the Texas Supreme Court on December 16, 1987.

ARGUMENT

I. THE DECISION OF THE SUPREME COURT OF TEXAS, REQUIRING HOUSTON TO REDUCE ITS RATES BY THE AMOUNT OF TAX BENEFITS RELATED TO ITS DISALLOWED COSTS, CONSTITUTES A TAKING WITHOUT COMPENSATION.

The Texas Supreme Court, in its Opinion and Judgment, required Houston to reduce its cost of service, on which its rates are based, by an amount equal to the tax benefits associated with the $166 million disallowance of ACNP costs. At the same time, the $166 million cost which gave rise to the tax benefits also was excluded from cost of service. This result constitutes a taking of property without compensation or due process in violation of the Fifth Amendment of the United States Constitution as applied to the States through the Due Process Clause of the Fourteenth Amendment.

A. The Tax Benefits Associated With the Disallowed ACNP Costs Should Inure to the Benefit of Houston's Shareholders.

The principle that utility regulators may not take non-utility property in order to subsidize utility rates is indisputable. Indeed, American public utility regulation rests upon that bedrock understanding. *See, e.g., Northern Pacific Railway Company v. North Dakota*, 236 U.S. 585, 595 (1915); *cf. El Paso Electric v. FERC*, 667 F.2d 462, 468 (5th Cir. 1983) (acknowledging that "customers should neither be burdened by losses from other service nor benefitted from non-jurisdictional profits").

Under the cost of service approach to ratemaking applied by the PUC, a utility must identify the total costs of providing utility service to its customers. *See* Section 39, Public Utility Regulatory Act, Art. 1445c, Tex. Rev. Stat. Cost of service is defined "as the sum of: (a) reasonable operating expenses, (b) depreciation expense, (c) taxes, and (d) a fair and reasonable return." *Suburban Utility Corporation v. Public Utility Commission of Texas*, 652 S.W.2d 358, 362 (Tex. 1983). *See also* 1 A.J.G. Priest, *Principles of Public Utility Ratemaking* 45 (1969). Only those costs *properly assigned to the utility operation* may be included in the cost of service. *Tennessee Gas Pipeline v. FERC*, 606 F.2d 1094, 1109 (D.C. Cir. 1979), *cert. denied*, 445 U.S. 920 (1980); *cf. Columbia Gulf Transmission Company*, 23 F.E.R.C. (CCH) ¶ 61,396, at 61,850 (1983) (costs are to be included only "on the basis of a causal link between the service the company provides them and the expenses the company reports").

The PUC's decision to disallow $166 million in ACNP costs precludes their recovery in rates, leaving these costs to be borne entirely by shareholders. Ratepayers never paid any part of this amount. Therefore, for utility ratemaking purposes, the $166 million disallowed costs associated with ACNP are to be treated as a non-utility or below-the-line cost.

The taxes normally included in a utility's cost of service are not "all taxes incurred by the utility" as stated by the Texas Supreme Court (*Houston*, 748 S.W.2d 441), but only those taxes incurred by the utility in providing utility service. Otherwise, all taxes paid by a utility, whether incurred to provide utility service to ratepayers or as a non-utility item, would be the responsibility of the ratepayers. However, ratepayers do not receive the benefit of a utility's non-utility income nor are they burdened with the detriment of the associated taxes. Neither should they benefit from the tax effects of a utility's non-utility losses where they are not burdened with the detriment of the losses. *City of Charlottesville, Virginia v. FERC*, 774 F.2d 1205, 1207 (D.C. Cir. 1985), *cert. denied*, ___U.S. ___, 106 S.Ct. 1515 (1986) ("*City of Charlottesville*"). Therefore, the tax effects of the disallowed ACNP costs, costs borne entirely by shareholders, should benefit the shareholders, not the ratepayers.

B. The PUC Confiscated Property From Houston's Shareholders Without Compensation.

The property here at issue is the tax benefit associated with the disallowed ACNP costs. The "benefit" in question in *Houston* is the reduction in taxes resulting from the loss deduction attributable to the

abandonment of property. The Texas Supreme Court determined that Houston's ratepayers are entitled to that benefit even though it was the shareholders, not the ratepayers, who paid for the abandoned property. The PUC, as affirmed by the Texas Supreme Court, having treated the $166 million of ACNP costs as non-utility property with no recognition in rates, have seized the associated tax benefits from the Houston shareholders without any form of compensation or due process. Similarly in GSU's case, the PUC has seized the tax benefits associated with various below-the-line costs and transferred some $30 million per year from shareholders to ratepayers without any compensation or due process.

As stated above, the principle that utility regulators may not take non-utility property in order to subsidize utility rates is well-founded. The question in a particular case, of course, is whether the regulatory treatment there at issue is a "taking". The character of the governmental action in this case is extraordinary despite the regulatory setting in which that action occurred. Behind the screen of a ratemaking proceeding, the PUC has seized the tax benefits related to an investment in property for which the PUC expressly denied shareholders any compensation.

After excluding Houston's $166 million investment from cost of service (as well as from rate base), the PUC appropriated for ratepayers the tax attributes of the investment, which the PUC valued at $111 million. Houston's cost of service, from which the $166 million "non-utility" investment already had been excluded, was reduced by $111 million to take the

entire benefit of the tax reduction. Of course, had Houston not made the $166 million investment, there would have been no associated tax effect nor would there have been any impact on Houston's cost of service. In fact, Houston did make the $166 million investment, and the PUC specifically excluded the amortization of the investment from recognition in Houston's rates. Whatever the merits of this exclusion as a ratemaking matter, had the PUC stopped at this point then the effect on Houston's ratepayers would be the same as if Houston had never made the investment, *i.e.*, there would be no effect on Houston's rates. However, the PUC went further, to seize the tax benefits of the investment from Houston's shareholders and appropriate them for Houston's ratepayers. The PUC has given Houston's ratepayers $111 million that they would not have had if Houston's shareholders had never invested the $166 million in ACNP, at the same time that the PUC has excluded the $166 million as a cost in determining Houston's rates.[2]

---

[2] Simple justice requires that ratepayers should not benefit from the tax savings resulting from the utility's non-utility losses. *City of Charlottesville*, 774 F.2d at 1217. Otherwise, ratepayers may not pay any cost-of-service taxes, even though the utility itself has tax expenses. Consider a utility company with two non-utility operations—one which created a $100 tax refund, the other a $100 tax liability. The company's utility operations also produced a $100 tax liability. If the PUC's longstanding procedures are applied properly, the tax loss and tax liability resulting from the non-utility operations are not considered in determining cost-of-service tax expense. Then ratepayers would pay a $100 tax liability produced by the company's utility operations. Under the inequitable flow-through procedure adopted by the PUC, as affirmed by the Texas Supreme Court in *Hous-*

The constitutionality of such regulatory action must be tested under traditional Fifth and Fourteenth Amendment principles. *Brooks-Scanlon Company v. Railroad Commission of Louisiana*, 251 U.S. 396 (1920) ("*Brooks-Scanlon*"), is a case in point. In *Brooks-Scanlon*, the state railroad commission had refused to allow a timber company to abandon an unprofitable railroad operation on the ground that the company's non-utility operations generated sufficient income for the company to make a profit notwithstanding the loss from the railroad operation. The Court used ordinary Fifth and Fourteenth Amendment standards flatly to reject the view that benefits from non-utility property could be taken to reduce utility rates. *Id.* at 399. Similarly, this Court, upon review of this case, should conclude that the PUC's action, as affirmed by the Texas Supreme Court, is no less a confiscatory taking than that condemned by the Court in *Brooks-Scanlon*.

C. Frustration of Reasonable Investment-Backed Expectations Also Constitutes an Unconstitutional Taking.

The present case involves a taking like that found unconstitutional by the Court in *Ruckelshaus v. Monsanto*, 467 U.S. 986 (1984) ("*Monsanto*"). In *Monsanto*, the Court declared that an unconstitutional taking would exist if certain reasonable investment-backed expectations of Monsanto's shareholders were frustrated.[3]

---

ton, the tax benefit of the non-utility loss is credited to the ratepayers while any non-utility tax liability is ignored. Hence, ratepayers pay no tax in cost-of-service even though utility operations created the liability. The result is that the company has a $100 utility tax liability borne solely by its shareholders.

[3] Over a period of years, Monsanto had submitted to the En-

The Court has ruled that neither complete destruction of property nor the exercise of physical control over property is necessary for an unconstitutional taking to occur. *See, e.g., Pennsylvania Coal Company v. Mahon*, 260 U.S. 393 (1922); *Kaiser Aetna v. United States*, 444 U.S. 164 (1979). As the Court declared in *Monsanto*, 467 U.S. at 1005, "Governmental action short of acquisition of title or occupancy has been held, if its effects are so complete as to deprive the owner of all or most of his interest in the subject matter, to amount to a taking", *quoting United States v. General Motors Corporation*, 323 U.S. 373, at 378 (1945).[4]

In *Monsanto*, the Court ruled that frustration of Monsanto's reasonable investment-backed expecta-

---

vironmental Protection Agency ("EPA") data which Monsanto considered to be trade secrets. At all times during which Monsanto had submitted data to the EPA, it was aware of the standard operating procedure of the agency with respect to the confidentiality of information submitted.

With respect to data submitted when EPA was not required to maintain the confidentiality of data it received, the Court found that Monsanto could have no reasonable expectation in the confidentiality of the submitted data. However, the Court ruled that a reasonable investment-backed expectation did exist with regard to the treatment of information submitted while EPA had a mandate to maintain confidentiality of the data it received. Therefore, any unauthorized release or use of such information by the EPA would constitute a taking. *Monsanto*, 467 U.S. at 1011, 1013. The Court remanded the case for further proceedings to determine whether reasonable expectations existed with respect to the particular property at issue.

[4] The decision of the Texas Supreme Court, while not destroying or acquiring title to the tax benefits in question, effectively denies Houston's shareholders—the rightful owners—of *all* interest in these tax benefits and thus in property rights.

tions constituted a taking, where its shareholders' reasonable expectations related to the specific property in controversy. The present case presents the same frustration of investment-backed expectations without a similar question or uncertainty regarding the property in controversy. Houston's shareholders had a reasonable investment-backed expectation that, at worst, they would receive the tax benefits resulting from the loss incurred by a cancellation of ACNP. The PUC's ruling and the Texas Supreme Court's affirmance thereof deprived Houston's shareholders of that expectation.[5]

This Court should grant Houston's appeal in order to reaffirm its conclusion in *Monsanto* that regulatory frustration of reasonable investment-backed expectations constitutes a taking of property without compensation or due process in violation of the Fifth Amendment of the United States Constitution as applied to the States through the Due Process Clause of the Fourteenth Amendment.

II. THE COURT'S DECISION IN *FPC V. HOPE NATURAL GAS COMPANY* DOES NOT JUSTIFY THE ACTION OF THE PUC AND THE SUPREME COURT OF TEXAS.

The PUC may attempt to justify its actions on the basis of the declaration by the Court in *FPC v. Hope*

---

[5] The GSU situation is even more compelling. Certain expenses, such as lobbying costs, were incurred by GSU shareholders with no intention even of attempting to recover these business expenses from ratepayers through rates. GSU shareholders' only reasonable expectation was that they would receive the tax benefits of the expenses, because shareholders alone bore the burden of those costs. The PUC has deprived GSU shareholders of that reasonable expectation by seizing the tax benefits and transferring them to GSU's ratepayers.

Natural Gas Company, 320 U.S. 591, 602 (1944) ("*Hope*"), that "it is the result reached and not the method employed which is controlling". However, while *Hope* indicates that rates which provide a reasonable return for the utility investment in property dedicated to public use are permissible, *Hope* does not sanction confiscation of non-utility property from a utility's shareholders in order to reduce utility rates. Moreover, *Hope* calls for a balancing of the interests of utility shareholders and ratepayers. *Id.* at 603.

Here, the action of the PUC is plainly beyond *Hope*. The PUC has taken property (the tax benefits associated with the $166 million disallowance) unrelated to the utility's allowed cost of service from its shareholders and appropriated them for the utility's ratepayers. The issue here is not the end result of the PUC's ratemaking determination of a utility's cost of service, but rather the PUC's appropriation of the tax benefits associated with property determined by it to be non-utility property for ratemaking purposes. The *Hope* decision might provide the test by which the adequacy of compensation for use of utility property is judged. However, the taking from shareholders of the tax effects of that disallowance is a confiscation of property that cannot be justified by the end result test applied to regulatory determinations of utility cost of service.

CONCLUSION

WHEREFORE, for the foregoing reasons, Gulf States Utilities Company respectfully requests the Court to grant Houston Lighting & Power Company's appeal and to reverse the decision of the Supreme Court of Texas.

Respectfully submitted,

Raymond F. Dacek*
Floyd L. Norton, IV
David E. Jacobson
Michael D. Paul
Reid & Priest
1111 - 19th Street, N.W.
Washington, D.C. 20036
(202) 828-0100

Attorneys for
Gulf States Utilities Company

* *Counsel of Record*

August 1, 1988